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THESIS

Some Legal Conclusions Concerning Accepted Accounting Principles as Determined by Decisions of the United States Supreme Court and the United States Board of Tax Appeals Based on Cases under the Federal Income Tax Law.

by

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INTRODUCTION

As the title suggests, this work is in no way a complete treatment of the subject. The writer has tried to choose the more commonplace elements of the subject with the idea of indicating trends in this field rather than providing a technical reference book.

Almost all of the material is taken from cases decided by the courts and the Board of Tax Appeals.

It should be readily apparent that the emphasis in keeping financial records has shifted from the production of factual information upon which the proprietor, partners, or stockholders may build the policy of management to a most fruitful method of taxing the income of business enterprise regardless of facts. The sole objective appears to be a greater tax.

Except in businesses of the smallest calibre it is extremely unwise, not to say dangerous to the life of the business, to operate a set of records without the aid of an attorney or a tax specialist.

(1) Article 22 (a) - 2 of Regulations 26
(2) Article 22 (a) - 1 of Regulations 26

CHAPTER I

INVENTORIES

When a business in whole or ⁱⁿ part consists of the manufacture, production or purchase and sale of personal property except products or fruits of the soil and in a few isolated trades such as oyster culture, inventories are required. Real estate is excluded from the requirement. In some cases such as with farmers, fruit growers, cotton planters, and so forth, inventories are optional, but if the choice is exercised it must be adhered to in subsequent years unless a change is granted by the Treasury Department.

As to the date when an inventory is to be taken, the law⁽¹⁾ requires that the inventory of the entire business be taken at the same time. This does not mean that a "perpetual" inventory may not be used, though it is expected that such an inventory will be verified.

Our next question concerns the elements that are to compose inventory. These elements are defined by the regulations⁽²⁾ as all finished or partly finished goods and in the case of raw materials and supplies, only those which have been acquired for sale or which will physically become part of the merchandise intended for sale.

(1) Article 22 (c) -2 of Regulations 86
 (2) Article 22 (c) -1 Regulations 86

CHAPTER I INVENTORIES

When a business in whole or part consists of the manufacture, production or purchase and sale of personal property except products or fruits of the soil and in a few isolated trades such as system culture, inventories are required. Real estate is excluded from the requirement. In some cases such as with farmers, fruit growers, cotton planters, and so forth, inventories are optional, but if the choice is exercised it must be adhered to in subsequent years unless a change is granted by the Treasury Department. As to the date when an inventory is to be taken, the law (1) requires that the inventory of the entire business be taken at the same time. This does not mean that a "partial" inventory may not be used, though it is expected that such an inventory will be verified.

Our next question concerns the elements that are to compose inventory. These elements are defined by the regulations (2) as all finished or partly finished goods and in the case of raw materials and supplies, only those which have been acquired for sale or which will physically become part of the merchandise intended for sale.

(1) Article 22 (c) - 2 of Regulations 88
(2) Article 22 (c) - 1 of Regulations 88

After determining the content of the inventory the next logical consideration is the method of taking inventories. Section 22 (c) provides two tests to which each inventory must conform.⁽¹⁾

(1) It must conform as nearly as may be to the best accounting practice in the trade or business.

(2) It must clearly reflect income.

So long as the method closely conforms to the general custom of the trade the more important element is consistency. If this principle is adhered to and though there may be slight deviations from the trade practice the method will be considered to reflect clearly the income of the business. The Treasury Department has been overruled at times by the Board of Tax Appeals. The former contended certain results to be absurd⁽²⁾, but because of the element of consistency the latter considered the method to reflect the true income.

Before leaving the subject of method it might be well to note that it is very important that the final draft of inventory records be carefully incorporated in the accounting records because all inventories are subject to the investigation of the Commissioner.

(1) Regulations 86, Section 22 (c)

(2) Buss Company's Appeal 2 B.T.A. 266 (A)

(1) Pittsburgh Bridge and Iron Works v. Gleser 28 F. (2d) 809
(2) Article 22 (c) 3 Regulations 86

It should be further noted that the Board of Tax Appeals will refuse relief on the ground that the method of the Taxpayer is superior to that of the Commissioner unless he can, at the same time, show that the valuation obtained by him is more nearly correct than that of the Commissioner.⁽¹⁾

In the matter of valuation of inventories the law and general accounting are in noteworthy agreement. Section 22 (c) provides for two bases, cost and cost or market whichever is lower. There are other methods of valuing inventories but they are not in accord with the regulations.

It is here essential to clarify the meaning of the word COST. Where goods are inventoried at cost it means that all items are taken on a cost basis. The regulations⁽²⁾ give the following meanings.

a. Merchandise on hand at the beginning of the taxable year is considered to have cost the stated inventory price of such goods.

b. In the case of merchandise purchased cost is considered to be invoice price less trade or other discount except strictly cash discounts which approximate a fair interest rate, which may be deducted or not at option of taxpayer provided that he follows a consistent policy. What

(1) Pittsburgh Bridge and Iron Works v. Hiener 25 F (2d) 900
 (2) Article 22 (c) 3 Regulations 86

is considered cash discount is usually decided in each case. To this figure should be added transportation and other necessary charges incurred in acquiring possession of the goods but not handling and hauling charges. Also storage charges are not part of cost.

c. If the merchandise was produced by the taxpayer, cost includes these items:

- (1) Cost of raw materials and supplies entering into or consumed in connection with the product.
- (2) Cost of direct labor.
- (3) Indirect expenses incident to and necessary for the production of the article including a reasonable proportion of return on capital, whether by way of interest or profit.

If the process of manufacture results in two or more products the total cost may be allocated, but such allocation must bear reasonable relation to selling price of the respective articles.

- (4) For industries where these rules do not apply, costs may be approximated upon such a basis as may reasonably conform to trade practice on that particular industry.⁽¹⁾

(1) Regulations 86 Article 22 (c) 4

The term "market" as a basis for valuing inventories under ordinary conditions means current bid price prevailing at the date of inventory for the particular merchandise in the volume in which usually purchased by the taxpayer. This meaning is applicable in the following cases.

- a. Goods purchased and on hand.
- b. Basic elements of cost on goods in process and finished goods on hand, exclusive of goods on hand or in process for delivery upon sales contracts at fixed prices entered into before the date of inventory which must be inventoried at cost.

If there is not ^{an} open market or where quotations are nominal due to stagnant market conditions, the taxpayer must use such evidence of a fair market price at the dates nearest the inventory as may be available, such as specific purchases or sales by taxpayers or others in reasonable volume and in good faith.⁽¹⁾

Shopworn goods or goods unusable or unsalable in the ordinary way are termed abnormal goods. These may be valued in an exceptional way. Article 22 (c) 2 of Regulations 86 provides that such goods should be valued at bona fide selling prices less cost of selling whether cost or

(1) Regulations 86 Article 22 (c) 4

market, whichever is lower, is used as a basis for valuation. The taxpayer must establish the fact of abnormality before this method will be allowed him.

Permission for change of a basis of valuation may be obtained if grounds for change are reasonable. Retail dry goods dealers are allowed to change to "retail method" without obtaining formal permission.⁽¹⁾ Otherwise application must be made to the Commissioner within ninety days of the beginning of the taxable year at the end of which the inventory method is to be changed.

No hybrid combination of retail, cost, and cost or market, whichever is lower, method is permissible.

Where permission to change the basis for valuation is granted and not availed of in the return for the year, the new basis cannot be subsequently used.⁽²⁾

In using the cost or market value, whichever is lower, it has been ruled by the Treasury Department that in the same inventory some items may be taken at cost while others may be valued at market where the latter is below the former. In the use of this method it is assumed that the rule of first-in, first-out is applied to the goods.

The "retail method" of valuing inventories is allowed to certain classes of taxpayers provided

(1) C. B. III 1, 64; Mimeograph 3180

(2) Trinidad Brick and Tile Company v. Commissioner 8 B.T.A.

1. The use of such method is designated on the return.
2. That accurate accounts are kept.
3. That this method is consistently adhered to unless permission to change has been granted.

Under this method approximate cost is obtained by deducting from total selling prices an amount which bears the same ratio to such total as:

1. The total of retail selling prices of goods in opening inventory plus retail selling prices of goods purchased during the year, with proper adjustment to such selling prices for all mark-ups and mark-downs less
 - a. The cost of goods included in the opening inventory plus the cost of goods purchased during the year bears to (1). This difference should represent the amounts added to the cost price to cover expenses and profit.⁽¹⁾

Miscellaneous notes on inventory follow. It should also be noted that in a departmental business percentages of gross profit should be applied to the respective departments and not combined into an average percentage which is applied to all departments.

(1) Montgomery's Federal Income Tax Handbook, 1935-1936, pp. 141-144

In regard to percentages, "gross mark-up" percentage and not "net mark-up" percentage is used by the Treasury in determining taxable income of merchants using the retail method.⁽¹⁾

Under retail method a taxpayer may value his inventory on the basis of cost or market, whichever is lower, provided cost, computed under retail method of each item, is compared with market value and the lower of the two used as the inventory value.

If a partnership is succeeded by a corporation, must the latter value its inventories on the same basis as the former? The answer is no. The corporation may value its inventories on any method accepted by the Treasury.⁽²⁾

Merchandise belongs in inventory only if title has passed to the taxpayer.⁽³⁾

Supplies kept for sale to employees at cost are not to be considered inventory.

Postage on C.O.D. shipments is included in the closing inventory only in the year it is paid.⁽⁴⁾

Materials delivered to a smelting company, later to be returned, are not handled as a bailment but as a sale.

(1) Montgomery's Federal Income Tax Handbook, 1935-1936, pp. 141-144.

(2) Ibid, p. 145

(3) Prentice Hall Tax Service, 1936, p. 9503

(4) Ibid, p. 9505

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- (1) Montgomery's Federal Income Tax Handbook, 1935-1936, pp. 141-144.
 (2) Ibid, p. 145.
 (3) Revenue Ruling, 1935, p. 2503.
 (4) Ibid, p. 2503.

Only the metal returned by the smelter is to be included in inventory. (Case where ordinary accounting principles do not apply.)

An important exception to choice of cost or market is merchandise held on firm contracts at fixed prices. If this is the case this merchandise must be inventoried at cost.⁽¹⁾

If a request for change of basis of valuing inventories is granted it will be unnecessary to file amended returns for prior years or the opening inventory of the present year.⁽²⁾

If a mistake causes inventory to be partly calculated at cost when it should have been at market, the taxpayer is entitled to have tax computed on the correct base. That is the market value in this case.⁽³⁾

In regard to inventory of used automobiles, regulations provide that the taxpayer is entitled to use sale price as a base less expense of disposition, which expense evidence has shown to be at least 25%.⁽⁴⁾ of sale price.

Carrying charges may be included in inventory values. This does not include interest unless merchandise is carried on borrowed money.

(1) Prentice Hall Tax Service, 1936, p. 9580

(2) Ibid, p. 9585

(3) Ibid, p. 9586A

(4) Ibid, p. 9590

Bonuses paid to employees who participated in production of goods should be included in inventory of those goods when inventory is taken on a cost basis.⁽¹⁾

In the light of the preceding evidence it is clear that so far as inventories are concerned the courts and the Treasury Department are in agreement with and have based their findings and regulations on the generally accepted accounting principles.

In the first place, the claim for depreciation must be reasonable as determined by known conditions of the end of the taxable period.

If the cost or other basis of the property has been recovered through depreciation or other allowances, no further deduction for depreciation shall be allowed.

The burden of proof now rests on the taxpayer to sustain deduction claimed. Therefore, the taxpayer must furnish full and complete information with respect to cost or other basis of the asset. This, in brief, includes age, condition and remaining useful life, and the portion of their cost or other basis which has been recovered in prior taxable years.⁽²⁾

(1) Prentice Hall Tax Service, 1936, p. 9680

(2) For detailed information reference is made to Ruling 4190 (C.B. XII-1) 89, of the Bureau of Internal Revenue.

CHAPTER II

DEPRECIATION

Depreciation may be defined for income tax purposes as the gradual exhaustion, wear and tear of property through use in a trade or business, including "normal obsolescence". (1)

Article 23 (1)-5, Regulations 86, sets forth some of the salient points on this subject.

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(1) Bulletin F, January 1931, p. 2

(2) For detailed information reference is made to Mimeograph 4170 (C.B. XIII-1) 59, of the Bureau of Internal Revenue.

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(1) Bulletin F, January 1931, p. 2
(2) For detailed information reference is made to
Mimeograph 4170 (C.B. XIII-1) 86, of the Bureau
of Internal Revenue.

To quote from Mimeograph 4170, if upon the review of the return of the taxpayer it is apparent that the deduction for depreciation is a very minor factor in determining net income, or if facts show conclusively that deduction claimed is not in excess of correct amount, or where it is evident that no taxable income will be developed, schedules need not be furnished for such year. No particular form is required.

Meaning of depreciable property. Illustrations of property not used in trade or business are building or plant under construction, residential property used exclusively as home for taxpayer, furniture of private dwelling, personal effects, automobiles and other conveyances solely for personal use.⁽¹⁾

No depreciation is allowed on an abandoned plant. This does not mean suspension of operations for temporary causes.

Regulation 86, Article 23 (1)-2 states that if a private dwelling is used partly for professional purposes, or the part of a wardrobe used by an actor in his business, such parts may be depreciated for tax purposes.

Bulletin F states that this same principle holds in the case where the taxpayer rents a portion of his personal residence.⁽²⁾

(1) For greater details see Bulletin F, January 1931, p. 17.
 (2) Ibid, p. 19.

Some of the important items used in trade or business which are not depreciable are inventories, containers, and land.

In the case of containers, the Treasury department stated that the cost should be capitalized and depreciated. However, the Board of Tax Appeals found that the taxpayer's method of charging them to customers and crediting their accounts upon their return of the containers, and the showing of containers in gross sales more clearly reflected the income with the result that the taxpayer's method was sustained.

Land presents a different situation. No change is allowed until land is sold and at such time a negative change is considered loss and not depreciation.

Intangible items used in a trade or business, which items have a definitely limited life or duration, are depreciable. This principle includes contracts and efficiency systems.⁽¹⁾

Patents belong in this classification. In this country the life of a new patent is seventeen years. Sometimes momentum is gained and the value continues beyond seventeen years, but this value is largely goodwill and, therefore, not deductible. If the patent is leased it should

(1) United Profit-Sharing Corporation vs. United States, Ct. Cls. 171
 Evens and Howard Sewer Pipe Company vs. Becker 70 F (qd) 596

not be considered an asset. If a corporation uses a patent owned by a stockholder free of charge, the corporation may not take depreciation on it. If patents were bought for stock the cost of the patents is fair market value of shares in the open market. Occasionally there is not established value for patents. In such a case the Board of Tax Appeals has set off the rule that in determining value under such conditions consideration should be given to history and volume of profits produced by the patents and further, the opinion and testimony of men experienced in dealings in patents. It is advisable to keep very clear records of income from royalties as these are valuable as supporting evidence.(1)

If there are several patents they should be valued separately. This is a requirement of the Treasury department.

The cost of defending or perfecting title to property constitutes part of cost and is not a deductible expense.(2)

Copyrights. These rights are charged off under the same procedure as patents except that the term in the United States is twenty-eight years. Caution is needed here for most copyrights diminish rapidly in value. If a twenty-eight year base is used periodical revaluations ought to be made.(3)

(1) Regulations 86, Article 24-2.

(2) Ibid

(3) Montgomery's Federal Income Tax Handbook, p. 573.

Leaseholds have been provided for in Treasury regulations so that where a specified sum was paid for them and they are used in trade or business, the straight-line method may be used in writing off these leaseholds and deduction made on the tax return.

By whom depreciation may be deducted. The ruling is that allowance for depreciation and/or obsolescence may be claimed by individuals, citizen or alien, resident or non-resident; fiduciaries of estates and trusts; partnerships; corporations, domestic or foreign, with respect to property actually used in trade or business and recognized by the Bureau as subject to depreciation or obsolescence or both. (1)

Depreciation of leased property. In general, depreciation to lessee, of the cost of or other allowable basis of the improvements made by him, is subject to the same rules which govern depreciation of the lease. If useful life of improvements ^{is} less than life of lease, or if improvements may be removed at end of lease, or if tenancy is indefinite or on a month by month basis, the ordinary or usual rules of determining depreciation will apply.

There are some special cases under the heading of leases that require separate mention.

(1) Bulletin F, p. 16

The Treasury has ruled that when the lessee is obligated to return leased property, unimpaired in value, neither the lessee nor the lessor is entitled to deduct depreciation during the term of the lease.

Where landlord and tenant are affiliated corporations, improvements made to the leased premises by the tenant are to be depreciated over their life and not over the life of the lease.

Care is needed in deciding when improvements constitute deductible expense and when such are capital investments subject to depreciation. When the lessee's interests are practically the same as the lessor's, the cost of such improvements are capital investments.

If a renewal lease is effected before the old one expires, and improvements had been made prior to the new one, the cost should be amortized from the date of expenditure to the date of the renewal lease upon the basis of the original lease. The unamortized balance should be treated as a capital investment to be spread over the new lease.⁽¹⁾

May the lessor deduct depreciation? When improvements are erected on the lessor's property he may report the income on one of the following bases:

(1) C.B. IV-1, 142; S.R. 2499

- a. Fair market value at time of completion.
- b. Fair market value of improvement subject to the lease.
- c. May spread over life of the lease the depreciated value of improvements as at expiration of lease and report as income an aliquot part thereof.⁽¹⁾

It can be seen that the lessor, at least in section (c), is allowed to deduct depreciation.

Basis upon which depreciation may be determined.

The general rule is that the basis for property acquired as of February 28, 1913 is cost; for property acquired prior to March 1, 1913, the basis is fair market value as of that date or cost adjusted as provided in Section 113 (b), whichever is greater.

Adjusted basis means that all changes in an asset, for example, readaptation, increased load, efficiency improved, additions, losses, must be taken into consideration in determining gain or loss on disposition or in computing annual depreciation. It also includes the requirement that entire depreciation allowed or allowable in prior years must be deducted in case of disposition, regardless as to whether or not such depreciation was taken at the time of wear and tear.

(1) Regulations 86, Article 22 (a) -13.

a. Fair market value at time of completion.

b. Fair market value of improvement subject to the lease.

c. May spread over life of the lease the depreciated value of improvements as at expiration of lease and report as income as a part thereof. (1)

It can be seen that the lessee, at least in section (c), is allowed to deduct depreciation.

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Adjusted basis means that all changes in an asset, for example, revaluation, increased loss, efficiency improved, additions, losses, must be taken into consideration in determining gain or loss on disposition or in computing annual depreciation. It also includes the requirement that entire depreciation allowed or allowable in prior years must be deducted in case of disposition, regardless as to whether or not such depreciation was taken at the time of wear and tear.

(1) Regulations 66, Article 22 (a) -13.

Repairs and renewals. The accountant's solution is to draw an arbitrary line between relatively small items of incidental repairs and maintenance and the heavy items of renewals and replacement, charging the former to expenses and the second to depreciation reserves.

Repairs in the nature of replacements, to the extent that they arrest depreciation and appreciably prolong the life of the property, should be charged to the property account rather than to the reserve.

Alterations not in the nature of repairs which were made to obtain increased rentals were not allowed as deductible expenses.

If changes in assets were numerous during the year and in small amounts they may be considered to have occurred ratably during the year and depreciation computed on the average of opening and closing balances of the account.

Property exchanged or traded in for like property. There is no recognition of gain or loss on an exchange of property for like property used productively in a trade or business.

Method of computing depreciation. The Treasury prefers the straight line method, but there is no fixed rule. The Board of Tax Appeals, in the case of Evangeline Gravel Company, Incorporated vs. Commissioner (13 B.T.A. 101) gave as part of its decisions....."but the facts in each

case must be carefully considered, together with the surrounding circumstances, and then, in the light of such facts and surroundings, a deduction made which shall constitute a reasonable allowance." (1)

In Bulletin F it is ruled that in the case of the extraction of natural resources it more accurately reflects income if the unit of production method is used. (2)

Sometimes a change of method is needed. Ordinarily a method must be used consistently. Where the straight-line method is satisfactory while a factory is operating full time, however, when such factory goes on part-time operation the depreciation may be more accurately accounted for by using the unit of production method.

Section 23 (1) provides that a "reasonable allowance" for depreciation shall be allowed as a deduction. This means that the actual rate is a local affair. What might be true of an asset in one situation might in no way suit the same asset in a different situation. This situation exists in relation to almost all other classes of property.

Useful life of property. The deduction for depreciation is usually dependent upon the expected useful life of property rather than its physical life. (3)

- (1) Evangeline Gravel Company, Inc. vs. Commissioner,
13 B.T.A. 101
- (2) Bulletin F, January 1931, p. 13
- (3) First National Bank in Mobile vs. Commissioner,
30 B.T.A. 632 A

With regard to machinery there is the possibility of extraordinary wear. It is not necessarily true that if a machine is used twice as many hours a day, the depreciation will be twice as great. There are several cases on record where deductions for extraordinary depreciation have been allowed.⁽¹⁾ Of course, substantiation will be required of the taxpayer in so far as he deviates from a standard rate.

Considerable discussion is given to the use of composite rates of depreciation. It might be worth noting that most of the disallowances in depreciation rates ruled by the Treasury were found to be on a composite basis. If from the accounting standpoint it is impracticable to segregate assets into classes, then the Treasury may be considerate. However, in general, it will be worth the extra effort to keep separate accounts and separate rates.

In conclusion, there are some truths which it would be well to emphasize, one being that though the so-called straight-line method of depreciating assets is preferred by the Treasury Department and is consistent with good accounting, it should be remembered that the rule is "reasonable allowance". What might be considered a reasonable allowance

(1) Wilkes-Barre Lace Manufacturing Company's Appeal,
B.T.A. 467 A
Hickory Spinning Company's Appeal, 2 B.T.A. 439 A

for a factory running at capacity may not be the same allowance in the case of the same factory running at 50% of its capacity. Another situation should be kept in mind along the thought that the same asset may depreciate at different rates in different places, which makes the subject of depreciation rates a local affair.

b. The deduction of specific bad debts in whole or in part.

One of these two methods must be chosen and followed continually unless the Commissioner grants permission to change. (1)

A prerequisite of a bad debt is the legal relationship of debtor and creditor or no debt is considered to exist. (2)

A contingent liability is not a bad debt; (3) neither is a mere cause of action for breach of contract sufficient basis for deduction. (4)

The amount paid by a guarantor may be deducted as a bad debt if his right to reimbursement from the principal debtor is worthless and he charges off the sum paid within the taxable year. (5)

(1) Montgomery's Federal Income Tax Handbook, 1935-1936

(2) *Boas Company vs. Commissioner*, 26 B.T.R., p. 409

(3) *Blanchard vs. Commissioner*, 17 B.T.R., p. 1271

(4) *Wadsworth Manufacturing Co. vs. Commissioner*, 15 B.T.R., p. 1227

(5) *Keya vs. Commissioner*, 4 B.T.R., p. 1256 A

CHAPTER III

BAD DEBTS

The law offers a choice of two methods in computing deductions for bad debts.

- a. A reasonable addition to a reserve for bad debts.
- b. The deduction of specific bad debts in whole or in part.

One of these two methods must be chosen and followed continually unless the Commissioner grants permission to change.⁽¹⁾

A prerequisite of a bad debt is the legal relationship of debtor and creditor or no debt is considered to exist.⁽²⁾

A contingent liability is not a bad debt;⁽³⁾ neither is a mere cause of action for breach of contract sufficient basis for deduction.⁽⁴⁾

The amount paid by a guarantor may be deducted as a bad debt if his right to reimbursement from the principal debtor is worthless and he charges off the sum paid within the taxable year.⁽⁵⁾

(1) Montgomery's Federal Income Tax Handbook, 1935-1936

(2) *Ross Company vs. Commissioner*, 26 B.T.A., p. 499

(3) *Blanchard vs. Commissioner*, 17 B.T.A., p. 1271

(4) *Wadsworth Manufacturing Co. vs. Commissioner*, 15 B.T.A., p. 1237

(5) *Heyn vs. Commissioner*, 4 B.T.A., p. 1256 A

The taxpayer is allowed the deduction only when he actually pays the guaranteed debt. The giving of a promissory note does not constitute payment.⁽¹⁾

It should be made clear that if the indemnitor has no claim against the principal debtor or renounces his right of reimbursement, there is no right of deduction because of no debt to be charged off.⁽²⁾ However, when a debt is shown to be worthless, deduction thereof will not be barred by the creditor's voluntary release of the debtor.⁽³⁾ This does not apply to solvent debtors.

It is important to note the difference between bad debts and losses because a loss is deductible in the year in which it is sustained while a bad debt is only deductible in the year in which its worthlessness is ascertained and in which it is charged off.⁽⁴⁾

Embezzlement gives rise to a loss when the criminal act occurs, unless what has been taken had been held by the taxpayer as an agent, in which case no loss is incurred until the agent makes good the defalcations of his employee. No deduction for bad debt is permitted.⁽⁵⁾

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- (1) Eckert vs. Burnet, 283 U.S. 140
 - (2) Menihan vs. Commissioner, 79 F (2d) 304
 - (3) Brown et al vs. Commissioner, 10 B.T.A., 1036 A
 - (4) Montgomery's Federal Income Tax Handbook, 1935-1936
 - (5) Grenada Bank vs. Commissioner, 32 B.T.A., 1290

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he actually pays the guaranteed debt. The giving of a

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 - (4) Montgomery's Federal Income Tax Handbook, 1935-1936
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The unfortunate result of considering a loss as a thing of the present is that the loss may not be discovered until several years afterward, as in the case of embezzlement,⁽¹⁾ which means that no deduction is allowable if not discovered in that taxable year.

There is a way of circumventing this situation. If after the discovery of an embezzlement, the embezzler enters into an agreement to repay the embezzled funds, and the taxpayer subsequently ascertains that the indebtedness thereby created is worthless, a deduction can be taken under the bad debt section of the law.⁽²⁾

If the debt is secured by an insurance policy the Board has held that the taxpayer may deduct as a bad debt the difference between the amount of the debt and the cash surrender value of the policy.⁽³⁾

It was held that a taxpayer is entitled to deduct a bona fide worthless debt due him from a corporation of which he was the principal stockholder.⁽⁴⁾

Taxpayers should keep in mind that the time when a debt is ascertained to be worthless and not the time when it actually becomes worthless is the controlling factor.⁽⁵⁾ Further, the taxpayer has the burden of proving that an

(1) Montgomery's Federal Income Tax Handbook, 1935-36, p. 528

(2) Douglas County Light and Water Co. vs. Commissioner, 43 F (2d) 904

(3) Ross vs. Commissioner, 72 F (2d) 122

(4) Selden vs. Heiner, 12 F (2d) 474

(5) Wheeler Fisher and Co. vs. Commissioner, 54 F (2d) 294

indebtedness was ascertained to be worthless within the taxable year and the taxpayer must present facts upon which such ascertainment was made.⁽¹⁾

The ascertainment of the worthlessness of a debt, either in whole or in part, is the exercise of sound business judgment based upon as complete information as is practically obtainable.⁽²⁾

"The taxpayer is neither required to be an incorrigible optimist and ignore the worthlessness of a debt that stares him in the face, nor throw good money after bad to get a judgment of a court and the failure of a sheriff to demonstrate a fact he already knows."⁽³⁾

Where the taxpayer, because of family ties or personal relations between himself and his debtor, is not willing to enforce payment of his debt, in whole or in part, he is not thereby entitled to deduct it from his income tax as worthless.⁽⁴⁾

The fact that a debt has not matured is merely a circumstance to be taken into consideration in ascertaining whether the debt is worthless.⁽⁵⁾

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- (1) Georgia Engineering Co. vs. Commissioner, 21 B.T.A. 532A
 - (2) John E. Saddler's Appeal, 2 B.T.A. 1305 A
 - (3) U. S. vs. White Dental Co., 274 U.S. 398
 - (4) Thom vs. Burnet, 55 F (2d) 1039
 - (5) Robert Smith Corporation vs. Commissioner, 21 B.T.A. 1400

The flight or disappearance of the debtor is usually sufficient evidence of worthlessness to justify a charge-off.⁽¹⁾

If there is a solvent surety on the principal debtor's obligation the creditor does not have a worthless debt merely because the principal debtor is insolvent. He must exhaust his efforts to collect from the surety or establish the fact that the surety is insolvent.⁽²⁾

Mere failure to pay on demand is not sufficient proof of the worthlessness of a debt.⁽³⁾

The taxpayer entered into a contract with certain patentees to manufacture guns according to specifications required under certain contracts between the patentees and the government. The contract provided that the taxpayer should be paid out of funds to be paid the patentees by the government. The guns proved to be defective and were rejected by the government. The patentees brought suit against the government. The claim was finally disallowed in 1918 by the Court of Claims, by which time the patentees had died insolvent. It was held that the amount due the taxpayer on the contract was deductible as a bad debt in 1918.⁽⁴⁾

(1) Jones' Appeal, 2 B.T.A., 1218 (A)

(2) Tunnelton Bank vs. Commissioner, 12 B.T.A., 187A

(3) Prescott State Bank vs. Commissioner, 11 B.T.A., 147

(4) Birdsboro Steel Foundry and Machine Co. vs. U.S.,
3 Fed. Supp., 44

Bankruptcy, receivership or insolvency as a test:

"Unsecured and unpreferred debts" are distinguished from others, indicating in practically all cases of bankruptcy that there may immediately be charged off at least part of "unsecured or unpreferred debts." (1)

Bankruptcy, receivership or insolvency in themselves are not sufficient to establish the worthlessness of a debt. (2) However, the fact that the petitioning creditors thought that the bankrupt had sufficient assets to justify filing a petition is not sufficient to overcome clear evidence that the debt was uncollectible. (3)

The Board held that a deduction for a debt already ascertained to be partially worthless would be denied to a creditor of an insolvent corporation which assigned its claim to a creditors' committee and subsequently received stock from the new corporation organized by the committee to take over the assets of the old corporation. (4)

Depreciation of collateral as a test: When a debtor who has put up collateral is known to be unable to pay and the collateral security is worth substantially less than the amount of the debt, it is not necessary first to

(1) Montgomery's Federal Income Tax Handbook, 1935-36, p. 536

(2) H. B. Moore vs. Commissioner, 8 B.T.A., 749 (a)

(3) Patten and Davies Lumber Co. vs. Commissioner, 45 F (2d) 556

(4) Rockford Brick and Tile Co. vs. Commissioner, 31 B.T.A., 537

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 - (3) Fatten and Bayles Lumber Co. vs. Commissioner, 45 B.T.A. 566
 - (4) Rockford Brick and Tile Co. vs. Commissioner, 21 B.T.A., 537

sell the security before the amount of the secured debt can be ascertained to be worthless, charged off and deducted. (1)

The value of such security may be estimated. (2)

Unless a creditor accounts for his security and brings in evidence of its value, he will not be permitted to deduct anything for his bad debts. (3)

Statute of limitations as a test: A debt continues to exist until it is satisfied. The statute of limitations does not destroy it. It is merely a defense which must be affirmatively pleaded. (4)

Subsequent advances to the debtor as a test: Frequently a creditor lends money or extends credit to a debtor whose previous debts have been charged off as worthless. This does not mean that the debts which were charged off were not ascertained to be worthless in good faith. The fact that the taxpayer exercised poor business judgment, or reasonably believed that further advances were necessary to prevent further losses, should not deprive him of his deduction. (5)

The fact that a debt reasonably ascertained to be worthless and charged off as such was subsequently recovered

(1) Ross vs. Commissioner, 72 F (2d) 122

(2) Capitol City Bank vs. Grissom, 50 F (2d) 1056

(3) Stranahan vs. Commissioner, 42 F (2d) 729

(4) Stein's Appeal, 4 B.T.A., 1016

(5) Midland Coal Company's Appeal, 1 B.T.A., 311 (a)

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- (1) *Ross vs. Commissioner*, 72 F. (2d) 122
 - (2) *Capital City Bank vs. Gleason*, 30 F. (2d) 1026
 - (3) *Stranahan vs. Commissioner*, 42 F. (2d) 722
 - (4) *Stein's Appeal*, 4 B.T.A., 1012
 - (5) *Midland Coal Company's Appeal*, 1 B.T.A., 211 (2)

in part or in full is not in itself sufficient to prevent a deduction.⁽¹⁾

When the proceeds of a foreclosure sale are sufficient to satisfy only the first lien, the subsequent liens may be charged off, if action against the debtor would be fruitless.⁽²⁾

In order to justify the deduction as a bad debt of all or part of a deposit in a closed bank, a depositor should obtain at the close of his taxable year a statement from the receiver or other liquidating agent of the bank setting forth how much, to the best of his judgment, will ultimately be recovered by the depositor. It has been held that such a statement is evidence of the worthlessness or partial worthlessness of the claim.⁽³⁾

It is to be remembered that reorganization is not liquidation and that if a bank is reopened and depositors have waived a percentage of their deposits for which they received an interest in certain assets placed in trust for their benefit, no determination of worthlessness can be made.⁽⁴⁾

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- (1) Meurer Steel Barrel Co. vs. Commissioner, 7 B.T.A., 64 A
 - (2) Leavenworth's Appeal, 1 B.T.A., 754
 - (3) Egan and Hansman Co. vs. Commissioner, 1 B.T.A., 556 A
 - (4) Montgomery's Federal Income Tax Handbook, 1935-36, p. 542

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- (1) *Henry Steel Barrel Co. vs. Commissioner*, 7 B.T.A., 64 A
 - (2) *Leavenworth's Appeal*, 1 B.T.A., 754
 - (3) *Egan and Hansen Co. vs. Commissioner*, 1 B.T.A., 526 A
 - (4) *Montgomery's Federal Income Tax Handbook*, 1935-36, p. 242

Meaning of "charge-off": Whether a charge-off has been effected is not dependent upon any special form of bookkeeping, but must be determined from the circumstances in each case. The effective elimination of the debt as an asset meets the statutory requirement as to charge-off.⁽¹⁾

It is not the physical act done within the year to which Congress has referred, but the setting up of evidence of the ascertainment of worthlessness substantially as of the date of such ascertainment and in confirmation thereof.⁽²⁾

It is well settled that if a taxpayer on his books eliminates a debt as an asset he has complied with the law.⁽³⁾

If no books of account are kept it was held that a taxpayer's deduction of debt on his tax return met the requirements of the statute.⁽⁴⁾

Where a taxpayer submits a list of accounts receivable to a prospective purchaser of its assets and the prospective purchaser marks certain accounts as worthless, the law has not been thereby complied with.⁽⁵⁾

It appeared that a decedent went over his affairs a few days prior to his death and stated to his son that

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- (1) Ewald and Co. vs. Commissioner, 18 B.T.A., 1130 A
 - (2) Appeal of Mason Machine Works Co., 3 B.T.A., 754 A
 - (3) George H. Fraser vs. Commissioner, 6 B.T.A., 997 A
 - (4) John H. Perry vs. Commissioner, 22 B.T.A., 13 N.A.
 - (5) Fairless vs. Commissioner, 67 F (2d) 475

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all money matters with a certain individual were a total loss and should be forgotten. The decedent kept no personal books of account. It was held that the debt had in effect been "charged off".⁽¹⁾

Credits to an account designated as "Interest in Suspense" were "entries of uncertain meaning, indicating doubtful items rather than debts charged off after having been ascertained to be worthless."⁽²⁾

In a case involving the liquidation of a subsidiary corporation it was held that the parent had effected a charge-off by crediting its accounts receivable with the amount of the debt.⁽³⁾

Although no entry was made in the ledger account charging off the amount of the debt, it was nevertheless held that the requirement of the law had been met when the taxpayer eliminated the amount of indebtedness from his balance sheet and credit statements.⁽⁴⁾

In regard to the meaning of "Within the Taxable Year", the book entries need not actually be made within the taxable year.⁽⁵⁾ However, if a debt is charged off after

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- (1) Shaw, Guthrie, Executor vs. Commissioner, 9 B.T.A. 459 A
 - (2) American Cigar Co. vs. Commissioner, 66 F (2d) 425
 - (3) Houghton & Dutton Co. vs. Commissioner, 26 B.T.A. 52
 - (4) George H. Fraser vs. Commissioner, 6 B.T.A. 997 A
 - (5) Chicago Railway Equipment Co. vs. Blair, 20 F (2d) 10

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- (1) Shaw, Guthrie, Executor vs. Commissioner, 9 B.T.A. 439 A
 - (2) American Cigar Co. vs. Commissioner, 36 F. (2d) 423
 - (3) Roughton & Lutten Co. vs. Commissioner, 23 B.T.A. 32
 - (4) George H. Krazer vs. Commissioner, 6 B.T.A. 337 A
 - (5) Chicago Railway Equipment Co. vs. Blair, 30 F. (2d) 10

the close of the taxable year, it must appear that the charge-off was intended to be made as of the end of the taxable year.⁽¹⁾

Basis of bad debt deduction: Where accounts receivable have been purchased, absence of proof with respect to cost precludes any deduction.⁽²⁾

Inasmuch as a debt, worthless when acquired, adds nothing to the assets of the creditor, there is nothing to be charged off when the fact of worthlessness is determined.⁽³⁾

Reserves for bad debts: The existence of economic conditions was recognized and it has been held that in determining what is a reasonable addition to a reserve the experience of past years is not controlling or necessarily material.⁽⁴⁾

The Board, while refusing to hold that a reserve may not be larger than the amount of actual or average bad debts in the past, stated that a reserve should not be out of proportion to what appears to be necessary on the basis of past experience unless good cause is shown.⁽⁵⁾

Where the taxpayer is reporting on instalment sale transactions and adopts the cash receipts and disbursements method as the basis for determining his profits,

(1) First National Bank, Danville, Ind. vs. Commissioner, 11 B.T.A., 671

(2) Elmore Milling Co. vs. Commissioner, 27 B.T.A., 84 A

(3) Eckert vs. Burnet, 283 U.S. 140

(4) Rhode Island Hospital Trust Co. vs. Commissioner, 29 F (2d) 339

(5) C. P. Ford Co. vs. Commissioner, 28 B.T.A., 156

no allowance can be made for a reserve to protect unpaid instalments.⁽¹⁾

Both the Board and the courts have upheld the Treasury in disallowing the deduction of the addition to reserve for bad debts as well as actual bad debts charged off against income.⁽²⁾

Change of method: Although the regulations require that an application for permission to change the method of treating bad debts be made thirty days prior to the close of the taxable year of which the change is sought to be made, it is held that the requirement is waived if the Commissioner accepts and approves a return based on the new method.⁽³⁾

Accounting procedure where method of deducting bad debts is changed:

1. Set up a reserve for bad debts before closing the books as of the close of the taxable year, which is to be credited with:

- a. The amount of the reserve which should have been set up at the close of the preceding year.
- b. An allowance for uncollectible amounts arising from the business of the taxable year, which

(1) Voliva vs. Commissioner, 36 F (2d) 212

(2) First National Bank of Omaha vs. Commissioner, 49 F (2d) 70

(3) Ganahl Lumber Co. vs. Commissioner, 21 B.T.A. 118 A

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(1) Voliva vs. Commissioner, 35 F (2d) 212
(2) First National Bank of Omaha vs. Commissioner, 49 F
(3d) 70
(3) General Lumber Co. vs. Commissioner, 21 F.T.R. 113 A

may be based on the same percentage of the charge sales for that year which the uncollectible accounts were of the charge sales for the previous three years or five years. This basis, however, is subject to modification if business conditions during the three or five-year period have been unusually good or bad, or if another method is better adapted to the business.

2. Charge against the reserve suggested above all the accounts determined to be uncollectible and charged off during the taxable year:

- a. The aggregate of such accounts accrued prior to the beginning of the taxable year.
- b. The aggregate of such accounts accrued during the year.

3. The allowable deduction for bad debts in the return for the year of change and for subsequent years is I (b) unless due to conditions in the taxable year it is necessary to provide additional reserve for accounts on hand at both the beginning and end of the taxable year for which sufficient reserve is not provided, as at the beginning of the year. (1)

(1) Montgomery's Federal Income Tax Handbook, 1935-1936, pp. 553-554.

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 year. (1)

This chapter presents some very interesting side lights from the tax point of view which do not really concern us as accountants from the standpoint of principle--for example, the changing of an embezzlement which may be a non-deductible loss to a condition of indebtedness which later proves worthless and qualifies as a bad debt.

The procedure of the two public authorities in the case of bad debts largely conforms to that of good accounting. There is a point that needs attention in connection with a situation where our bad debts have exceeded our reserve. Both the courts and the Board frown upon an attempt to deduct the addition to reserve for bad accounts together with deductions for actual bad debts charged against income. It is well, therefore, to be sure that our reserve is high rather than low if we are using the reserve method.

CHAPTER IV

TAXES

It is frequently a matter of some difficulty to determine exactly when a particular tax accrues.

Only a word need be said with reference to the contention that the tax upon munitions manufactured and sold in 1916 did not accrue until 1917. In a technical legal sense it may be argued that a tax does not accrue until it has been assessed and becomes due, but it is also true that in advance of the assessment of a tax, all the events may occur which fix the amount of the tax and determine the liability of the taxpayer to pay it.

In this respect, for purposes of accounting and of ascertaining true income for a given accounting period, the munitions tax here in question did not stand on any different footing than other accrued expenses appearing on the appellee's books. In the economic and bookkeeping sense, with which the statute and Treasury decision were concerned, the taxes had accrued. It should be noted that Section 13 (d) makes no use of the words "accrue" or "accrued", but merely provides for a return upon the basis upon which the taxpayer's accounts are kept, if it reflects income--which is precisely the return insisted upon by the Government. We do not think that the Treasury decision contemplated a

return on any other basis when it used the term "accrued" and "accrual" and provided for the deduction by the taxpayer of items "accrued on their books".⁽¹⁾

Taxes should be accrued as of the date when they first become a liability of the taxpayer. This is true even though the period with respect to which they are assessed may not coincide with the taxpayer's taxable year.⁽²⁾

The accrual of a tax and the time when its deduction may be secured are not postponed by a claim of exemption.⁽³⁾

Decisions of the Board hold that the taxes for a given year accrue on the date on which the state law creates a liability for the tax on the part of the taxpayer though it be not due or payable that year.⁽⁴⁾

Taxes are not deductible in the year of payment by a taxpayer on the accrual basis if they accrue under the law in a prior year.⁽⁵⁾

The provision for deductions of taxes "paid or accrued within a taxable year" has been held not to refer to the payment of arrears of taxes, on the ground that to hold otherwise would be to permit the postponement of a deduction.⁽⁶⁾

(1) U. S. vs. Anderson, 269 U.S. 422

(2) Niles, Bement, Pond Co. vs. U.S., 281 U.S. 357

(3) Continental Baking Corp. vs. Helvering, 69 F (2d) 392

(4) Crown Williamette Paper Company vs. Commissioner,
14 B.T.A. 133 A

(5) Great Northern Railway vs. Commissioner, 30 B.T.A. 691

(6) Westerfield vs. Rafferty, 4 F (2d) 590

Where accurate records of tax payments are not kept a taxpayer may claim credit for all taxes paid if the claim is made in good faith and can reasonably be supported. Since in the case of admission and similar taxes, receipts are not given by those who collect the taxes, vouchers cannot be furnished. If one's memory is trustworthy no reasonable objection can be made to a claim based on the taxpayer's statement. This does not apply to taxes paid by check.(1)

By whom taxes are deductible. The test of the deductibility of a tax is whether the tax is imposed upon the person desiring to make the deduction.(2)

The sales tax upon manufacturers of automobiles is not deductible by the purchaser of an automobile notwithstanding that it may be specifically passed on to him as a part of the purchase price.(3)

A mere volunteer is not permitted to deduct payments for taxes. When the payer has an interest in the property, even though only a partial interest, the deduction is allowable provided the interest carries some measure of liability to pay.(4)

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- (1) Montgomery's Federal Income Tax Handbook, 1935-36, p. 457
 - (2) Regulations 86, Article 23 (c) -I
 - (3) Hamilton vs. Commissioner, 6 B.T.A., 240
 - (4) Nicodemus vs. Commissioner, 26 B.T.A., 125 A

Where a husband paid taxes on property owned by his wife it was held that he is not entitled to a deduction.⁽¹⁾ Nor is the husband entitled to a deduction if he pays the tax because he is bound to do so under a mortgage executed prior to the conveyance of the property by him to his wife.⁽²⁾

A corporation which pays a tax deficiency assessed against another corporation whose liabilities it had assumed pursuant to a merger agreement may not deduct the amount so paid since the payment was part of the purchase price of the merged corporation.⁽³⁾

A similar decision applied to the payment by a successor corporation of real estate taxes accrued prior to the reorganization, on property which was acquired in the reorganization from the predecessor corporation.⁽⁴⁾

When the personal property of an estate was insufficient to pay all of the inheritance taxes, the devisees paid the difference to avoid a sale of the real estate. The Board held that the tax paid by one of the devisees was deductible in his return.⁽⁵⁾

A taxpayer acquired by foreclosure, subsequent to January 1 of the taxable year, various properties against

(1) Colston vs. Burnet, 59 F (2d) 867

(2) Small vs. Commissioner, 27 B.T.A. 1219

(3) Automatic Sprinkler Co. vs. Commissioner, 27 B.T.A., 160

(4) Merchants Bank Building Co. vs. Commissioner, 32 B.T.A., 1072

(5) Waller vs. Commissioner, 8 B.T.A., 935

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- (1) Colston vs. Burnett, 58 F (2d) 867
 - (2) Small vs. Commissioner, 37 B.T.A. 1812
 - (3) Automatic Sprinkler Co. vs. Commissioner, 37 B.T.A., 180
 - (4) Merchants Bank Building Co. vs. Commissioner, 32 B.T.A., 1072
 - (5) Weller vs. Commissioner, 8 B.T.A., 935

which taxes had been assessed as of January 1. The taxpayer paid all assessments on the acquired properties. It kept its books on the accrual basis, and sought to charge to cost of the properties that proportion of the assessment which accrued between January 1 and the date of foreclosure, and to deduct as taxes the remaining proportion of the assessment. The Board held that no part of the assessment was deductible. Complete liability was in the owner as of January 1. The taxpayer was thus paying the tax of another.⁽¹⁾

A taxpayer acquired property on June 11, 1927. Taxes for 1927 became a lien on May 1, 1927. They were payable in 1928. The taxpayer accrued the unpaid tax at December 31, 1927 and deducted the amount in its tax return. The Treasury contended that the taxes for 1927 having become a lien on May 1 and the taxpayer having acquired the property in June, he was paying some one else's debts and his payment therefore constituted additional cost of property.⁽²⁾ In other words, the taxpayer occupied the premises for more than half the year 1927, taxes were running on day by day during occupancy and were an expense if there ever can be such a thing as expense, and yet the taxpayer is told at December 31, 1927: "your taxes for the past six months were not an

(1) First Bond and Mortgage Co. vs. Commissioner, 27 B.T.A., 430

(2) Leamington Hotel Co. vs. Commissioner, 26 B.T.A., 1004 A

operating expense of your business. You can make up an honest profit and loss statement and omit one of your very large expense items and thus make a good showing. Your taxes were really capital expenditures."⁽¹⁾

Taxes deductible. Payments made for internal revenue stamps affixed to bonds are deductible in their entirety in the year of payment.⁽²⁾

Incorporation fees or taxes as deductions depend upon whether a sum paid to a state for the privilege of incorporating or changing the capital structure is deductible in full currently, or must be included in the capital organization expense items; it depends on whether the sum is exacted as a fee or a tax.

The criteria for distinction used by the Board are not too clear but may be summarized as follows:

1. Does the local statute exacting the sum prescribe use of the proceeds for general state purposes?
2. Is the amount in excess of any benefit accruing to the corporation, as well as in excess of the cost of the service rendered?

If these can be answered in the affirmative, the sum is deductible as a tax.⁽³⁾

(1) Montgomery's Federal Income Tax Handbook, 1935-1936, pp. 461-462

(2) Baltimore and Ohio R.R. Co. vs. Commissioner, B.T.A. 30, 194 A

(3) Montgomery's Federal Income Tax Handbook, 1935-1936, p. 468

Taxes not deductible. Penalties imposed for fraudulent or delinquent returns are penalties and not taxes, hence they are not deductible as taxes. (1)

The deposit of bonds with the taxing authority to secure the payment of taxes does not constitute a payment of the taxes by a taxpayer on the cash receipts basis so as to permit the deduction thereof. (2)

A distinction between improvements which tend to increase the value of the property and those which are merely for the purpose of maintenance must be drawn. (3)

The construction of parks, viaducts, and traffic ways was financed by special assessment in benefit districts. The improvements were held to tend to increase the value of the property and hence the assessments were held non-deductible. (4)

An assessment for the cost of street sprinkling is a tax, as sprinkling does not tend to increase the value of adjoining property. It is therefore deductible. (5)

A corporation was assessed for the paving of a street fifty feet away from its business property. It was shown that the market value of the land after the street

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- (1) Achelis vs. Commissioner, 28 B.T.A., 244
 - (2) Estate of B. Piller vs. Commissioner, 29 B.T.A., 799
 - (3) Montgomery's Federal Income Tax Handbook, 1935-36, p. 471
 - (4) Belfast Investment Co. vs. Commissioner, 17 B.T.A. 213 N.A.
 - (5) Mitchell vs. Commissioner, 27 B.T.A., 101 N.A.

was paved was no greater than before the pavement was laid and a deduction of the assessment was claimed. The Board denied the appeal on the ground that the corporation had not objected to the improvement or the assessment.⁽¹⁾

In regard to capitalized special assessments the questions arise as to whether deductions may be made for depreciation, an element of cost in calculating gain or loss on a subsequent sale or realization, or as a loss, whenever, or to whatever extent it becomes evident that the anticipated increase in value of the property has not developed.

In respect to the first of the questions a revoked ruling in the Hubbell case now permits deductions for wear and tear and obsolescence.⁽²⁾

Recognition of the item as an element of cost in calculating gain or loss on subsequent sale, there seems no doubt. If the assessment adds to the capital value of the property, it should be so regarded.

To the third question, no definite answer is to be found in the Treasury interpretation. It would seem reasonable to contend that a loss has been sustained which would be deductible within the statutory limitations applying to losses.⁽³⁾

(1) Caldwell's Appeal, 3 B.T.A., 1232

(2) Hubbell Son & Co. vs. Burnet, 51 F. (2d) 644

(3) Montgomery's Federal Income Tax Handbook, 1935-36, p. 473

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Taxes accrue on the date on which the state law creates a liability for the tax on the part of the taxpayer though it be not due or payable that year. This is important because under ordinary accounting methods, if a person occupied property for more than half of the year he would consider the tax a deductible expense. This, however, is not the fact because the tax was levied prior to ownership of the property which had existed for more than six months in that year. These taxes must be considered a capital item. Otherwise, there appears to be no conflict with accounting principles.

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CHAPTER V

DEDUCTIONS FOR EXPENSES

In general, deductions are limited to those specified in the law. A distinction must be drawn between "deductions" as provided by law and "charges to profit and loss account" as employed in accounting.⁽¹⁾

The law defines expenses which are deductible.⁽²⁾
In computing net income there shall be allowed as deductions:

- a. All ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business.

Stated differently, all expenses directly applicable to business income, even though the taxpayer is on a salary basis, are deductible. Among these are:

Dues to professional and business societies.

Expenses attending conventions.

Entertaining when necessary to get or keep business.

Certain traveling, including all other than to and from home.

Charges for business telephone and telegraph calls made from home.

Books and magazines relating to business.

(1) Montgomery's Federal Income Tax Handbook, 1935-36, p. 361
(2) Regulations 86, Section 23

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(1) Montgomery's Federal Income Tax Handbook, 1933-34, p. 361
(2) Regulations 88, Section 23

Such expenses are deductible though frequently disallowed because when claimed in a lump sum for an entire year with no reasonable detail.⁽¹⁾

The important criterion as to whether or not an expense is deductible is to what extent it is a direct or definite benefit to the business of the taxpayer.

Period in which expenses are deductible. The law states that deductions and credits shall be taken for the taxable year in which "paid or accrued",⁽²⁾ or "paid or incurred", dependent upon the method of accounting upon the basis of which the net income is computed.

In the distinction between business and personal expenses it is necessary to know what the Treasury means by "trade or business". The law⁽³⁾ states that these two words include all the individual's activities for gain, profit or livelihood, entered into with sufficient frequency, or occupying such portion of his time or attention as to constitute a vocation, including occupations and professions.

Where business expenses are intermingled with personal expenses, it is sometimes helpful to approach the problem in a negative fashion; that is, to ascertain amounts

(1) Montgomery's Federal Income Tax Handbook, 1935-36, p. 361

(2) Regulations 86, Section 43

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paid for personal, living and family expenses and to assume that the remainder represents business expenses. With such an assumption in mind, examination of the charges composing that remainder often reveals deductible items not otherwise apparent.

In connection with professional people it should be noted that expenses incurred in post-graduate courses are held to be personal, whereas expenses connected with research work are deductible.⁽¹⁾

Traveling expenses: Only amounts actually expended for traveling expenses including cost of a sample room, while away from home or business, are deductible. If the taxpayer is reimbursed, such amounts received must be included in gross income.⁽²⁾

If a deduction for traveling expenses is claimed, the taxpayer must attach to the return a statement showing:

1. Nature of business in which engaged.
2. Number of days away from home on account of business.
3. Total amount of expenses incident to meals and lodging while away from home.
4. Total amount of other expenses incident to travel and claimed as a deduction.⁽³⁾

(1) C. B. 5, 171; Office Division 984.
 (2) Regulations 86, Article 23 (a)-2.
 (3) Ibid.

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It might be an advantage to know that the Board is more liberal than the Treasury and revenue agents in its decisions regarding deductible expenses.

If a taxpayer travels continuously he may deduct all traveling expenses including amounts spent for meals and lodgings if he "maintains a house or other living quarters to which he may return at any time, or which is at all times available for his use." (1)

Entertainment expenses are deductible if it can be shown that business benefits were derived therefrom. It is, in all cases regarding expenditures for business expenses, advisable to keep careful records. However, deductions have been granted in several cases where no records were kept. (2)

With regard to an automobile which is used both for business and pleasure, about the only way to segregate the business expenses from personal expenses is to keep records. Regarding this particular item the Treasury is by no means liberal.

Business expense as distinguished from capital outlay. Accounting for organization expense and the handling of such expense on a tax return differ. From the

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accountant's standpoint all such expense that could reasonably be charged to current operations should be so charged. If there is any overage it should be spread over a term of three years but not over five.

The Board will not allow the deduction of organization charges as ordinary and necessary expenses.⁽¹⁾

When the charter is for a definite period an aliquot part of it may be deducted for each year.⁽²⁾ Note, however, that unless these are strictly organization expenses apart from cost of selling stock or anything else, no deduction will be allowed.

If the charter is for an indefinite period no deductions may be taken on an amortized basis, but on dissolution the organization expense may be deducted in full as a loss for that year.

Expenses incurred in selling capital stock are not deductible according to the Board and the courts. From the accounting point of view ordinary expenses in securing capital should not be capitalized. If it is not proper to capitalize an expense item, then it should be deductible as a business expense.

(1) Parker vs. Commissioner, 30 B.T.A. 1231

(2) Hershey Manufacturing Company vs. Commissioner, 43 F (2d) 298, modifying 14 B.T.A. 867 N.A.

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(2) *Herzberg Manufacturing Company vs. Commissioner*,
43 F. (2d) 258, modifying 14 B.T.A. 807 N.A.

Expenditures in connection with capital assets.

Bonuses paid to contractors for completing a building ahead of schedule are not deductible.

If alterations and improvements do not increase the value of the property beyond any reasonable doubt, the expenditures need not be capitalized.

A curious situation arises when a taxpayer seeks to deduct attorney's fees incurred in defending title to property. The deduction is disallowed.⁽¹⁾ The decision argued that these were not "ordinary or necessary expenses in carrying on the trade or business". On the other hand, such expenses are allowed every day by the Treasury. The difference lies in the fact that the recipients account, on their return, only for net receipts. It can be seen that the deduction was made, but outside of the return.

Experimental and prospecting expenses incurred in developing and testing an invention are capital expenditures.⁽²⁾

The cost of buying out competitors is held to be a capital expenditure^{and}/if definite benefits can be measured the deduction is allowed. Sometimes it is difficult to draw the line and the test hinges on whether or not there is a continuing benefit. If there is, then the item should be capitalized.

(1) Nail vs. Commissioner, 27 B.T.A., 33 A

(2) Canning vs. Commissioner, 29 B.T.A., 99 A

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(1) Hall vs. Commissioner, 29 B.T.A., 33 A
(2) Ganning vs. Commissioner, 29 B.T.A., 33 A

It is expected that amounts received by a retiring partner in excess of reasonable compensation, will be charged to goodwill. Even if the partner retiring receives an excess in the form of a pension it is still goodwill, according to the Treasury. When an incoming partner pays in excess of book value for his share, the excess is to be charged to goodwill and it may not be amortized.

The cancellation of the debt of a customer constitutes a capital expenditure.⁽¹⁾

In Harris and Company vs. Lucas the payment of former creditors the balances due them, where the taxpayer had been discharged under a composition agreement, was held by the courts to be deductible business expense.⁽²⁾

Expenses of business under receivership. In I.T. 2024 it was stated that expenses incurred in carrying on the bankrupt's business are deductible, but administrative expenses of the receivership, such as fees paid to attorney and fees paid to appraisers, are not deductible.⁽³⁾

Additional compensation allowed the receiver, under the National Bankruptcy Act, must be considered as compensation for carrying on the business of the bankrupt taxpayer and unrelated to the administration of the bankrupt estate.

(1) C.B. II 2, 157, I.T.1828

(2) Harris and Company vs. Lucas, 48 F (2d) 187

(3) I. T. 2024, C. B. III-1, 292

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(1) C. B. II 2, 187, I. T. 1923
(2) *Harvie and Company vs. Lucas*, 48 F (2d) 187
(3) I. T. 2024, C. B. III-1, 292

Salaries, wages, commissions and similar compensations. The law states that, in computing net income, there shall be allowed as deductions: (1)

All ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered.

The reasonableness of compensation rests upon those managing the business rather than on the Treasury. The factor of importance is good faith. (2)

From the cases passed on by the Board of Tax Appeals no general rule concerning reasonableness can be established, but weight is given to such points as

- a. Compensation paid by concerns of the same size in the industry.
- b. The relation to stock holdings.
- c. The time and manner of fixing the compensation.
- d. The ratio to the profits remaining after payment of the compensation.

Here again it is necessary for the taxpayer to submit proof.

(1) Regulation 86, Section 23

(2) Gray and Company vs. U. S., 35 F (2d) 968.

Salaries, wages, commissions and similar compensation

Section 162. The law states that, in computing net income,

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Here again it is necessary for the taxpayer to submit proof.

Bonuses and other special compensation. Bonuses to employees will constitute allowable deductions from gross income when such payments are made in good faith and providing that the total wage does not exceed a reasonable amount for the services actually rendered. (1)

Educational and welfare outlays for employees. When charitable or altruistic motives are uppermost, the cost should be entered on the books as gifts or donations. If the controlling motive is the betterment of the business, the cost is a business expense. (2)

Pensions to ex-employees and their dependents. Amounts paid by a taxpayer for pensions to retired employees or to their families or to others dependent upon them, or on account of injuries received by employees, and lump sum amounts paid or accrued as compensation for injuries are proper deductions as ordinary and necessary expenses. (3)

Premiums paid by an employer to an insurance company for past service annuities to employees constitute additional compensation and are deductible as such provided that the total does not exceed a reasonable wage for services rendered.

(1) Regulations 86, Article 23 (2) -8.

(2) Lihue's Appeal Two, B.T.A., 740 A.
Gulf, Mobile and Northern Railroad vs. Commissioner,
22 B.T.A., 233 N.A.

(3) Regulations 86, Article 23 (a) -9

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- (1) Regulations 36, Article 23 (2) - 2.
 - (2) Linn's Appeal Two, B.T.A., 749 A.
 - Gulf, Mobile and Northern Railroad vs. Commissioner, 32 B.T.A., 333 W.A.
 - (3) Regulations 36, Article 23 (a) - 2

Frequently arrangements are made where stock is sold to employees in such a way that the company pays part and the employee pays part. The amount paid by the company is deductible as a payment for services rendered.

If the arrangement is such that the stock is sold to an employee for a value below the market, such difference is considered additional compensation for services rendered. As to what year this amount is deductible depends upon the particular arrangement.

The Treasury will continue to disallow the deductions claimed for compensation paid unless the taxpayer furnishes it with the names and addresses of the persons to whom the compensation is paid.⁽¹⁾

Insurance. The law sets forth⁽²⁾ that "in computing net income no deductions shall in any case be allowed in respect ofpremiums paid on any life insurance policy covering the life of any officer or employee, or any person financially interested in any trade or business carried on by the taxpayer, when the taxpayer is directly or indirectly a beneficiary under such policy."

The foregoing section was held applicable to payments of premiums by a corporation on insurance policies

(1) C. B. XIII, 1, 47; Mm 4151

(2) Regulations 86, Section 24 (a)

Previously arrangements are made where stock is sold to employees in such a way that the company pays part and the employee pays part. The amount paid by the company is deductible as a payment for services rendered.

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(1) C. B. XIII, 1, 47; Reg. 4151
(2) Regulations 88, Section 24 (a)

covering the lives of its two principal sales agents where the taxpayer or its subsidiary was the beneficiary. One of the agents was a stockholder and as such was "clearly a person financially interested" in the taxpayer's business. The other agent was to receive as his compensation a share of the profits and so was financially interested in the business. (1)

Where a corporation's president pledges his life insurance policies as additional security for the payment of bonds and the corporation thereafter pays the premiums, it cannot deduct such payments. The corporation is indirectly a beneficiary under the policies. (2)

"Group" insurance premiums are deductible because the proceeds are paid to someone other than the taxpayer. (3)

"Group" insurance premiums are not considered income to employees. (4)

The cost of insuring property not owned but in which the taxpayer has an insurable interest is deductible on the ground that an insurable interest provides for ordinary and necessary expense. (5)

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- (1) Merrimac Hat Corporation vs. Commissioner, 29 B.T.A. 690
 - (2) Peerless Pattern Company vs. Commissioner, 29 B.T.A. 767
 - (3) Regulations 86, Article 24-3
 - (4) Regulations 86, Article 22 (a)-3
 - (5) Mortenson's Appeal, 3 B.T.A. 300

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| (1) | Harrison Nat Corporation vs. Commissioner, 29 B.T.A. 630 |
| (2) | Peerless Pattern Company vs. Commissioner, 29 B.T.A. 787 |
| (3) | Regulations 86, Article 24-3 |
| (4) | Regulations 86, Article 22 (a)-3 |
| (5) | Wortmann's Appeal, 3 B.T.A. 303 |

Premiums paid on insurance policies taken on a debtor's liens have been held deductible.⁽¹⁾ This finding also applies when insurance is taken out by a corporation on the life of a guarantor of a debt to the corporation.⁽²⁾

The difference between these premiums and those on officers or those financially interested is that the law will not recognize any special condition when the corporation is the beneficiary.

Premiums paid to insurance companies or state insurance commissions by employers under workmen's compensation laws are deductible. Even if these laws permit an employer to establish reserves for the purposes of carrying the risk himself, such reserves cannot be deducted, but payments to employees from such reserves are deductible.⁽³⁾

State banking corporations which are required by law to set aside certain amounts as a "depositors' guaranty fund" may deduct such amounts provided they cease to be assets of the bank and may be withdrawn upon demand by the designated state officer to reimburse depositors in insolvent banks and provided further that no portion of the fund is returnable to the banking corporation.⁽⁴⁾

(1) Dominion National Bank vs. Commissioner, 26 B.T.A. 421 A

(2) C. B. 5, 177, O. D. 1109

(3) C. B. 5, 118, O. D. 964

(4) Regulations 86, Article 23 (a) - 12

Premiums paid on insurance policies taken on a debtor's life have been held deductible. (1) This principle also applies when insurance is taken out by a corporation on the life of a guarantor of a debt to the corporation. (2)

The difference between these premiums and those on officers or those financially interested is that the law will not recognize any special condition when the corporation is the beneficiary.

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(2) C. B. S. 177, O. D. 1109
(3) C. B. S. 113, O. D. 284
(4) Regulations 86, Article 23 (a) - 12

Payments made by a bank into the temporary Federal Deposit Insurance Fund may be deducted as a business expense for the taxable year when the payment is made, irrespective of the contingency whereby a part of the payments may later be returned to the member bank.⁽¹⁾

Premiums paid by an employee on a fidelity bond necessary to his employment may be deducted in computing net income.⁽²⁾

Rentals. Where certain items of leased property were retired and in lieu of replacing such property the lessor was reimbursed, such expenditures represent rentals paid.⁽³⁾

The taxpayer, a building corporation, took over two leases by assignment, in order to procure the lessees as tenants for its own building. The rental paid on the assigned leases exceeded the rental received by reletting. The court held that the difference was deductible as a business expense and refused to uphold the contention that it was a capital investment, like a commission paid to procure a new tenant, which would have to be spread over the life of the tenancy.⁽⁴⁾

(1) C. B. XIII -1, 45; I.T. 2764

(2) T. D. 2090

(3) Atlantic Coast Lines Railroad vs. Commissioner 31 B.T.A. 730 A

(4) 379 Madison Avenue Incorporated vs. Commissioner, 60 F (2d) 68

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 (4) 379 Madison Avenue Incorporated vs. Commissioner,
 50 F (2d) 88

Cost of lease may be apportioned as rent. When a premium is paid to secure a lease, the amount represents an additional expense of doing business, the effect being the payment of a higher rent. This item is properly handled as a deferred asset. Since it represents increased rent, the rent paid and the proportion of premium are parts of one item. (1)

Assume a corporation issued \$100,000 of its capital stock to pay for a leasehold having thirty-one years to run. If the value placed on the leasehold was not excessive, the transaction was the same as if the corporation had sold its stock for cash and had then purchased the lease for cash. In that event it would have been proper to charge off each year as an expense $1/31$ of the amount paid. (2)

"Minimum" royalties in excess of actual production. A lessee may deduct as an expense the entire amount of royalties paid or accrued during the taxable year, notwithstanding that such payments may exceed the amount of royalties based upon actual production, provided the lessee acquires no absolute equity in the unmined coal. (3) This constitutes rent.

(1) *Baton Coal Company vs. Commissioner*, 51 F (2d) 469 cert. den. 284 U. S. 674

(2) *Federal Income Tax Handbook*, Montgomery, 1935-36, p. 416

(3) *Jamison Coal and Coke Company vs. Commissioner*, 24 B.T.A. 554 N.A. affd 67 F (2d) 342

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The Board of Tax Appeals allowed as ordinary and necessary expenses amounts expended for advertising purposes to defeat legislation which might be reasonably expected to injure the petitioner's business. These expenditures were for public advertising and employment of speakers to influence opinion and avert the enactment of proposed legislation. (1)

Contributions to state and county campaign funds were held to be non-deductible as business expenses, even though the petitioner was a candidate for the office of United States Senator. (2)

Trading stamps are considered a business expense when computing income from sales with which stamps or coupons are issued. The taxpayer is allowed to deduct therefrom only the value of the stamps or coupons issued during the taxable year which it is estimated will eventually be redeemed. Such estimate is to be based on past experience of the taxpayer and others engaged in similar business. (3) This really means that the law can be construed to permit a reserve when it serves the Treasury's purpose. (4)

Of a somewhat similar nature to trading stamps are premiums or prizes given for advertising purposes by business

(1) *Sunset Scavenger Company, Inc. vs. Commissioner*, 31 B.T.A. 758

(2) *David A. Read vs. Commissioner*, 281 U.S. 699

(3) Regulations 86, Article X, 42-5

(4) *Montgomery's Federal Income Tax Handbook*, 1935-1936

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- (1) United Scavenger Company, Inc. vs. Commissioner, 31 B.T.A. 758
 - (2) David A. Reed vs. Commissioner, 321 U.S. 639
 - (3) Regulations 86, Article X, 43-2
 - (4) Montgomery's Federal Income Tax Handbook, 1935-1936

houses. It is held that a restaurant may deduct the cost of an automobile given to the holder of a ticket bearing a certain number. (1)

Contributions paid to a corporation organized to attract business to a community and improve business conditions are deductible. (2)

The taxpayer and a predecessor corporation had infringed certain patents. After litigation, the taxpayer settled all claims against its predecessor and itself. It was held that the payments for infringement by the taxpayer were deductible, while those for infringement by the predecessor corporation were a capital expenditure. (3)

Payments made in settlement of a claim for which there is no legal liability are not deductible. (4)

Deductions for probable but uncertain expenses in general are of a doubtful value. The question arises first because of shifting of positions by the Treasury Department and the Board, and secondly, because reserves are not deductible. Where a liability is existent, good accounting dictates the provision of a reserve, but the Board claims that because the amounts are not precise there is

(1) C. B. II-1, 83; I. T. 1667

(2) The Hub, Inc. vs. Commissioner, 68 F (2d) 349
aff'g 26 B.T.A. 1201 N.A.

(3) Watah Paper Co. vs. Commissioner, 27 B.T.A. 488 N.A.

(4) White vs. Commissioner, 61 F (2d) 726

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(1) C. B. 11-1, 55; I. T. 1607
(2) The Hub, Inc. vs. Commissioner, 58 F. (2d) 549
aff'd 25 B.T.A. 1201 N.A.
(3) Watch Paper Co. vs. Commissioner, 25 B.T.A. 455 N.A.
(4) White vs. Commissioner, 51 F. (2d) 725

no legal right of deduction. An old accounting rule comes to bear on this point that indefinite incomes should be estimated at a minimum while indefinite liabilities should be estimated at a maximum.

The Supreme Court of the United States has upheld the duty of the taxpayer to include undetermined income.⁽¹⁾ It seems reasonable that the decision would hold true of expenses, but it is rather uncertain.

Attorney's fees. In general, it may be said that the determination as to whether or not these fees are deductible depends upon the matter concerning which the service was rendered.

Some of the situations where such expenses were disallowed are those having to do with trusts, rights to royalties, actions before the Federal Trade Commission, and prosecution of a suit for slander.

Some of the situations where attorney's fees were allowed as deductible expenses pertain to street assessments, sale of property of corporation, defending a civil suit for professional malpractice, defending a law partner's suit, recovery of war risk insurance premiums.

Generally stated, the same principle holds true with regard to accountants' fees.

(1) Continental Tie and Lumber Company vs. U.S., 286 U.S. 290

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Stock exchange membership fees represent capital additions and are neither deductible by the member nor taxable as income to the exchange.⁽¹⁾

Under this title the accountant will need to observe the law carefully. What might appear to him as a perfectly good profit and loss item might not be so looked upon by the Board and/or the courts.

An interesting feature is the fact that the Board will not allow the deduction of organization charges as an ordinary and necessary expense unless the charter is for a definite length of time, in which case an aliquot part of it may be deducted for each year.

A question arises in the case of expense incurred in selling capital stock. Neither the Board nor the courts consider this a deductible item, yet from the accounting point of view ordinary expense in securing capital should not be capitalized.

There are several other detailed exceptions to the usual accounting procedure, such as the special handling of attorney's fees, but the bulk of the procedure hinges on good accounting practice.

(1) C. B. VII-1, 120, General Counsel's Memoranda 4015

CHAPTER VI

DIVIDENDS

What Is A Dividend

Law: Section 115 (a) "The term 'dividend' when used in this title, (except in Section 203 (a) (4) and Section 207 (c) (1) relating to insurance companies) means any distribution made by a corporation to its shareholders whether in money or in other property, out of its earnings or profits accumulated after February 28, 1913." (1)

Section 801 (a-2) defines the term "corporation" as including associations, joint stock companies, and insurance companies. (2)

Interest or Dividend

An issue of stock carrying a guarantee of payments secured by a mortgage on all assets of the issuing corporation was held to constitute an evidence of indebtedness rather than a stock certificate and periodic payments to stockholders were interest, not dividends, and deductible. (3)

A corporation organized prior to March 1, 1913, and having on hand earnings and profits accumulated prior to that date, sustained a net loss in 1927, followed by earnings in 1928. It made distributions to its stockholders

(1) Montgomery's Federal Income Tax Handbook, 1936, p. 303

(2) Ibid

(3) Richmond, Fredericksburg & Potomac R.R. Co. (33 B.T.A. p. 896)

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during 1928 in an amount less than its earnings for that year. It was held that net income is not to be confused with accumulated earnings available for distribution, and current earnings are not required first to replace prior year's net loss before being available for distribution.

Congress provided in the law that "every distribution is made out of earnings or profits, and from the most recently accumulated earnings or profits, to the extent of such earnings or profits accumulated since February 28, 1913." (1)

Where a dividend was fully and unqualifiedly available to taxpayer in tax year, subject only to his demand therefor, it was held to be constructively received in that year. (2)

The rule of constructive receipt is a common one in accounting and the above statement is a reference to a concrete instance where the courts and the practice of accountancy coincide.

Taxpayer and his wife owned corporate stock as tenants by the entirety on which dividends were paid in tax year. It was held that in the absence of an agreement for the division of the dividends, the husband is taxable upon one-half thereof.

(1) R. M. Weyerhouser vs. Commissioner, 33 B.T.A., p. 594

(2) A. D. Saenger, Incorporated vs. Commissioner, 33 B.T.A. p. 135

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(1) R. M. Weyerhoefer vs. Commissioner, 33 B.T.A., p. 594
 (2) A. D. Bainger, Incorporated vs. Commissioner, 33 B.T.A. p. 128

The situation was that all of the dividends were reported on the wife's return whereas the Commissioner rightly maintained that half should have been reported by the husband. (1)

An amount which had its source in a dividend distribution on stock held in escrow and which, together with the stock, was paid as a fee to a law firm upon the successful termination of litigation concerning title to the stock. It was held that such amount was received by the firm as compensation for services and not as a dividend. (2)

If this stock had reached the hands of the members of the firm, the amount paid would have been considered dividends. The amount was first received by the escrow holders and later turned over as part of compensation.

Withdrawals from a corporation by its sole stockholder to the extent of his credit balance, without declaration of dividend by the corporation, were held to be dividends and advances made by him to the corporation in subsequent years were not payments on loans or security for loans to him. (3)

In this case the petitioner aided his own defeat by failing to keep proper records, both financial and others.

(1) Daniel Upthegrove vs. Commissioner, 33 B.T.A., p. 925

(2) Charles M. Thorpe, Jr. vs. Commissioner, 32 B.T.A., p. 767

(3) M. Jackson Crispin vs. Commissioner, 32 B.T.A., p. 151

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- (1) Daniel Updegrave vs. Commissioner, 33 B.T.A., p. 925
 - (2) Charles M. Thorpe, Jr. vs. Commissioner, 32 B.T.A., p. 487
 - (3) M. Jackson O'Brien vs. Commissioner, 32 B.T.A., p. 131

There was no record of any loan or interest or payment of dividends. The facts were definitely established that he was not in business to loan money and that according to the corporate charter it had no right to lend money.

A taxpayer was the sole stockholder of Gurhich, owned all the preferred and two-thirds of the common stock of Z. The remaining third of the common was owned by D. The taxpayer and D were indebted to Z, the former being solvent and the latter insolvent. Z was also insolvent and its indebtedness to G was substantially in excess of the value of the assets. Z cancelled the indebtedness of taxpayer and D. It was held that the cancelled indebtedness had the effect of the payment of a dividend by G to the taxpayer.⁽¹⁾

This case revolves around the fact that the taxpayer's own company pays him a dividend by allowing a subsidiary corporation to cancel the taxpayer's debt to it.

The Commissioner, in computing corporate surplus available for dividends, has applied losses against existing surplus to the extent of that surplus and applied the rest of the loss to the undistributed reserve for depletion. The net earnings of later years were treated as surplus without restoring the reserve. The petitioner claims that the reserve should be replaced before any profits are available

(1) Addison H. Gibson vs. Commissioner, 32 B.T.A., p. 836

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for dividends. The reserve actually is merely appreciation in value which was held by the court to be available for dividends and the payment did constitute a dividend and not a distribution of capital.⁽¹⁾

This was a surplus reserve set aside from earnings.

Stock Dividend Carrying Exclusive Rights To Assets

A dividend declared upon common stock payable out of authorized and unissued, preferred stock was held not to be a stock dividend where distributors had previously not owned any of the preferred stock; upon receipt thereof they acquired increased rights as to future dividends, and in the corporate assets, because under the terms of the preferred stock issue, distribution of assets upon liquidation was limited to holders of preferred stock.⁽²⁾

There was a great deal of discussion on this case but most of it concerned the taxability of the distribution rather than the accounting involved.

From the accountant's standpoint it seems to me that this is a strange agreement whereby the right to assets upon liquidation is distributed very much like a dividend on common stock. This might easily lead to the distribution of rights to assets which do not exist.

(1) Margaret P. Daly vs. Commissioner, 32 B.T.A., p. 965

(2) H. C. Gowran vs. Commissioner, 32 B.T.A., p. 820

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(1) *Margaret E. Daly v. Commissioner*, 32 B.T.A. p. 908
(2) *H. C. Gowen v. Commissioner*, 32 B.T.A. p. 830

Where a corporation's charter was cancelled by reason of failure to pay franchise tax, but was later reinstated by payment thereof, and during the period of suspension, the corporation continued to operate in the same manner and form as theretofore, it was held that there was no dissolution or liquidation, and the Commissioner erred in taxing the net worth of the business to stockholders as a liquidating dividend. (1)

Dividends are deemed payable from the most recently accumulated earnings and it was the contention of a taxpayer that such earnings should first be applied against losses sustained in earlier years, so as to leave available for payment of dividends only the surplus existing March 1, 1913. This contention is rejected. (2)

A corporation dividend declared and payable in one year, check for which was mailed in same year but not received by stockholder on cash basis until the following year, is income for the year in which payable--the earlier year. (3)

The particular purpose for which a subsidiary corporation was formed has been accomplished and there was no further need for its existence as a separate entity.

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- (1) Calvin Zimmerman & Wife vs. Commissioner, 31 B.T.A., p. 754
 - (2) Helvering vs. Canfield, 291 U.S. 193 followed R. S. Farrell, 30 B.T.A., p. 627
 - (3) Frederick S. Peck vs. Commissioner, 29 B.T.A., p. 872

It was held that distribution of its assets constituted liquidation although the subsidiary was not formally dissolved. (1)

In this case the petitioner sought to have returns filed on a consolidated basis under a New York Statute whereas the respondent felt that the Federal Statute should be the basis for judgment, to which justice agreed. The dividend of the subsidiary was considered one in liquidation.

It should be kept in mind that, though in the financial records of an organization a distribution may be called a dividend, this does not arbitrarily make such distribution a dividend. It is also true that what may not be intended for a dividend will be interpreted as such by the Commissioner. An example might be the cancellation of indebtedness.

(1) Frelmort Realty Corp. vs. Commissioner, 29 B.T.A., p. 181

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(1) *Freimont Realty Corp. v. Commissioner*, 32 B.T.A. 151.

CHAPTER VII

ACCOUNTING METHODS

Some Rulings of the Board of Tax Appeals
Covering Proper Accounting Methods

Royalties received in excess of royalties on production under minimum requirements are taxable income when received even though at some future time the excess may be applied to production above minimum requirements or the taxpayer may be required to pay the excess in the event that the field will not produce the minimum requirement.⁽¹⁾

In other words, it makes no difference as to any agreement between parties as to how income may be accounted for. It is taxable in entirety when received.

Income put in trust. A taxpayer sold stock in the tax year, receiving full payment for it, but in accordance with the terms of sale deposited part of the proceeds in the bank to insure his fulfillment of certain terms of agreement. It was held that the entire amount is income for the year in which received.⁽²⁾

This case bears out the principle of handling income shown in the preceding case. It makes no difference

(1) *Crosset Timber and Development Company vs. Commissioner*, 29 B.T.A., p. 705

(2) *Blaine I. Stoner vs. Commissioner*, 29 B.T.A., p. 46

how an organization chooses to spread its income on its own books; the law requires that it all be considered income when received.

The present case centers around accounting for commissions on sales of realty on deferred payments. Sales commissions were held as properly treated as a deductible business expense for the year in which paid rather than as a reduction of either the selling price of, or the initial payment on, the lots.⁽¹⁾

Commissions on estimated basis. A collection agency was entitled to commissions on payments made by debtors direct to clients, as well as on collections made by it. The agency retained its collections until the client reported receipts directly received, but in estimating earned commissions for income tax purposes, the agency omitted commissions earned on accounts collected by clients directly. It was held to be inaccurate, whereupon the court upheld the commissioner's average for the previous five-year period.⁽²⁾

In accounting for recoveries on accounts receivable purchased for cash, the aggregate value of numerous accounts receivable purchased for a lump sum may not be regarded as a single asset, the gain or loss remaining in suspense until the entire cash is recovered.⁽³⁾

(1) The Highlands Trust #1546, 32 B.T.A., p. 760

(2) National Adjusting Association vs. Commissioner, 32 B.T.A., p. 314

(3) O. H. Himelick vs. Commissioner, 32 B.T.A., 792

In determining a gain or loss on recoveries it was held proper to use the ratio of total cost to total face value.

This may be compared to the percentage of gross profit method of treating instalment payments.

An award by a court received in the tax year, held properly included as income for the year of receipt, was claimed by a taxpayer to represent payment for work performed under a long term contract which was earned in a prior year. The taxpayer's claim that its inclusion in the return for the present tax year was erroneous was rejected.⁽¹⁾

Erroneous accruals. Here is a case involving the inclusion in income by the Commissioner of credit balances consisting of items accrued on books six years or more prior to the tax year as liabilities for various items approved, where evidence does not disclose that such items represented true accounts payable or claims asserted against the petitioner in the years book entries were made.⁽²⁾

This is a very interesting case in that several points are involved. One is that it shows what may happen to a summary or catch-all account. It was carried for nearly fourteen years and finally ended up with a credit balance

(1) Herman J. Sternberg, 32 B.T.A., p. 1039

(2) North American Coal Company vs. Commissioner, 32 B.T.A., p. 535

due to a large number of unclaimed liabilities entered in the account. Therefore, the account was considered as an account payable.

In this particular state, Ohio, the Statute of Limitations calls for six years. As a result of this and also a ruling⁽¹⁾ from which we quote, "when a reserve or liability account, properly created in an earlier year, has ceased to be a true liability or reserve in a later year, it should be reversed and the amount thereof should be added to the income of the year when reversed."

It is interesting to note the United States Supreme Court's attitude on the subject of accounting.⁽²⁾ It was stated that books of account "are no more than evidential, being neither indispensable nor conclusive. The decision must rest on the actual facts."

A taxpayer on the accrual basis may not be charged with income which has accrued if there is good reason to believe that the income cannot be collected.⁽³⁾

In this case the company owing the money was insolvent. While an excess of liabilities over assets does not necessarily mean permanent insolvency, the facts were sufficient to show that probably the income would never be collected.

(1) Great Northern Railway Co. vs. Lynch, 292 Fed., p. 903

(2) Doyle vs. Mitchell Brothers Co., 247 U.S. 179

(3) American Fork and Hoe vs. Commissioner, 33 B.T.A., p. 1139

Book entries made in one year cannot be made applicable to the preceding year to support a loss deduction where there is no evidence as to when the books for the earlier year were closed so that the later entry could be regarded as a delayed incident of annual closing of books.⁽¹⁾

This case brings in the situation where bonds are written down at the direction of a national bank examiner. One might inquire as to whether or not such a direction makes the write-down a per se deductible item on the return.

The Board maintains, relying on a recent case,⁽²⁾ that unless such direction complies with the Revenue Act of 1928, in this case, the write-down is not deductible.

Where evidence established that the taxpayer's business was such that the inventory system of keeping books and making returns did not clearly reflect income and where the taxpayer, upon orders from the field examiner and the revenue agent in charge, changed to the cash basis, it was held that the Commissioner's refusal to consent to the change was unreasonable and arbitrary and returns filed should be accepted.⁽³⁾

This issue brings up the question as to whether or not the taxpayer may change his basis of reporting income without the express permission of the Commissioner.

(1) Citizens National Bank of Orange vs. Commissioner, 33 B.T.A., p. 758

(2) Second National Bank of Philadelphia vs. Commissioner, 33 B.T.A., p. 750

(3) Reynolds Cattle Company vs. Commissioner, 31 B.T.A., p. 206

The Board expresses its view in the following statement. "The primary purpose of the statute is to tax income and the computation must be made with this in view. To this end the Commissioner is authorized to approve any change in the method of computation, but his authority does not extend to the use of any method that does not clearly reflect income and he may not arbitrarily require the use of such method." (1)

A taxpayer on the accrual basis may not defer reporting income actually received because it was not earned and therefore not an accruable item on his books. (2)

The Board made its decision on the theory that the taxpayer had absolute right to the money. "It was under no restriction contractual or otherwise as to its disposition, use or enjoyment." (3)

From this and other cases it may be stated rather definitely that income is to be included for tax purposes regardless of the time of earning.

There are some very good points in this chapter, among which is the treatment by the Board of summary or catch-all accounts. Some accountants, particularly those

(1) Reynolds Cattle Co. vs. Commissioner, 31 B.T.A., p. 209

(2) C. H. Mead Coal Company vs. Commissioner, 31 B.T.A., p. 190.

(3) Brown vs. Helvering, 291 U.S. 193

in private practice, I believe, are tempted to use such accounts to get rid of troublesome items. The Board of Tax Appeals forces the analysis of such accounts or else it is very apt to consider those having credit balances as income items.

On the other hand, there is the question of deferred credits to income. This seems contrary to good accounting practice. Both the courts and the Board recognize the accrual method of keeping records, yet they will not recognize a deferred credit to income. The reason for the variance with the accepted methods of accounting is not explained by those authorities.

It is of value, that the taxpayer should be at liberty to consider what is likely to happen in the future, as well as in the present situation. (2)

The necessity that the buyer and seller be willing parties may be taken for granted or otherwise the requirement of "fair" market value would not be met. (3)

While the opinions of experts are respected and often very helpful, such evidence is not considered binding upon the tribunal before which it is produced, at least

(1) *Salmer vs. Grady*, 24 F (2d) 391

(2) *379 Madison Ave. Inc. vs. Commissioner*, 69 F (2d) 88

(3) *Ten-Pax Oil Co. vs. Commissioner*, 28 B.T.A. 217

CHAPTER VIII

GAINS AND LOSSES FROM SALE
OR EXCHANGE OF PROPERTY

Fair market value. The fair market price or value of stock at a particular time is a question of fact, to be determined from all the circumstances. Market price implies the existence of a market, of supply and demand, of sellers and buyers. Sales are always evidence of a market price, but the statute requires that, in "ascertaining the gain derived from a sale", there must be not simply a "market price", but a "fair market price".⁽¹⁾

The court said, with reference to the determination of value, that the taxpayer should be at liberty to consider what is likely to happen in the future, as well as in the present situation.⁽²⁾

The necessity that the buyer and seller be willing parties may be taken for granted or otherwise the requirement of "fair" market value would not be met.⁽³⁾

"While the opinions of experts are competent and often very helpful, such evidence is not considered binding upon the tribunal before which it is produced, at least

(1) Heiner vs. Crosby, 24 F (2d) 191

(2) 379 Madison Ave. Inc. vs. Commissioner, 60 F (2d) 68

(3) Tax-Penn Oil Co. vs. Commissioner, 28 B.T.A., 917

not to the extent that such tribunal is bound to follow it if contrary to the best judgment of its members.⁽¹⁾

In the absence of any sales of corporate stock around the basic date, and in the absence of any value of the stock of a subsidiary corporation, the value of the underlying assets of the corporation or of its subsidiary will be taken as a factor in determining the fair market value of the stock of the parent corporation.⁽²⁾

The petitioner's sole argument before us is that the prices at which small amounts of the stock were sold on the day of the decedent's death are not indicative of the fair market value of the large block of the stock owned by the estate, for the reason that an attempt to dispose of such large holdings would greatly depress the market,..... It frequently happens that the ownership of a large block of stock controls the management and policies of the corporation and that fact effects a great enhancement of value of the total holdings over that of smaller units. Consequently, the disclosure of the fact that the respondent's valuation is based upon sales price of but a few shares is not sufficient to prove it erroneous.⁽³⁾

However, it was held that stock exchange prices "at the peak of the stock inflation" are not conclusive as

(1) Thomas H. Tracy vs. Commissioner, 53 F (2d) 575

(2) McEwan et al vs. Commissioner, 26 B.T.A., 727 A

(3) Kier and McIntosh vs. Commissioner, 28 B.T.A., 633

to the "fair real value" and such value was determined from expert testimony. (1)

The Board held that volume of sales was not sufficient to establish a fair market price where the stock was not listed. (2)

Some times there is a question as to when a sale or exchange actually takes place. The broker, acting on the taxpayer's instructions, sold certain shares of stock on December 30, 1930. The certificates were inadvertently withheld by the taxpayer until January 5, 1931. The Board held that deduction of the loss was justified in 1930. The failure to deliver did not affect the certainty of loss. (3)

The placing of property in escrow until payment is made is not a closed transaction and there is no deductible loss unless and until the property is delivered or made available to the purchaser. (4)

The distinction made between cases where the vendor does and does not retain legal title is questionable. If the property is worth less when repossessed than when sold, even though the shrinkage in value is not due to statutory depreciation or obsolescence, the shrinkage should be recognized in determining any gain from repossession.

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- (1) Rogers vs. Strong, 72 F (2d) 455 (Federal Reports by groups of states)
 - (2) Rogers vs. Commissioner, 31 BB.T.A. 994
 - (3) Appleby vs. Commissioner, 31 B.T.A. 533
 - (4) Weis vs. Commissioner, 13 B.T.A. 1285 A

The retention of legal title does not prevent the original sale from being treated as a closed taxable transaction; it should not prevent the repossession from being treated as an exchange.⁽¹⁾

In the case of a sale on the instalment plan when title had not passed and the property was repossessed, the Board sustained the regulations and gave no consideration to the shrinkage in the fair market value of the property.⁽²⁾

This seems hardly fair to the vendor where an actual change in the fair market value can be shown.⁽³⁾

In a sale of property by a corporation to a majority stockholder for one-third of its stipulated value, the court sustained the Board in holding the regulation to be invalid. The court, following *Taplin vs. Commissioner*,⁽⁴⁾ held that under the Supreme Court's definition of income there was no "gain derived from capital" or "profit gained through a sale or conversion of capital assets". The court conceded that a transaction might take the form of a sale and represent a distribution, but indicated that in the absence of fraud or ulterior motive no income could be derived from a purchase.⁽⁵⁾

(1) *Heldt vs. Commissioner*, 16 B.T.A. 1035

(2) *Boca Ratone Co. vs. Commissioner*, 31 B.T.A. 1060

(3) *Montgomery's Federal Income Tax Handbook*, 1935-36, p. 156

(4) *Taplin vs. Commissioner*, 41 F (2d) 454

(5) *Commissioner vs. Van Vorst*, 59 F (2d) 677

The Board held the difference between the price of acquisition and the market value to be additional compensation when the evidence supported that conclusion.⁽¹⁾

Specific exceptions. For an exchange to fall under the above provision of the statute:

1. There must be an exchange and not a sale.
2. The property must be held for productive use in the business or for investment.
3. The property cannot be held primarily for sale.
4. The exchange must be for property of like kind.⁽²⁾

If a broker is instructed to sell one piece of property and purchase another with the proceeds, the transaction is a sale and not an exchange. There must be reciprocal transfer of property for property.⁽³⁾

A personal residence may or may not be held for investment according to the facts. If the taxpayer occupies the residence, then there is a natural inference that it is held for use rather than investment, but this inference may be overcome if a taxpayer can prove that he actually acquired the residence as an investment and occupied

(1) *Erskine vs. Commissioner*, 26 B.T.A. 147

(2) *Montgomery's Federal Income Tax Handbook*, 1935-36, p. 158

(3) *Detroit Egg Biscuit, etc., Co. vs. Commissioner*, 9 B.T.A. 1365 A

it temporarily merely to enhance its salability. Even though a residence was originally acquired for personal use, if it is subsequently rented as an investment property, it is held for investment.⁽¹⁾

Just as a dealer in securities may hold particular securities for investment, there is no reason why a dealer in real estate may not hold particular parcels for investment.⁽²⁾

Since the Treasury does not permit dealers in real estate to inventory, it might be argued that all real estate should, therefore, be treated as held for investment, but the Board has held to the contrary in connection with capital gain provisions.⁽³⁾

In the case of trade-ins, it is now the position of both the Treasury and the Board that when a business asset such as an auto, truck, or machine, is traded in for a new one with a cash payment, no gain or loss is recognized.⁽⁴⁾

When a loss is to be incurred in a trade-in the deduction of the loss can be taken if the old article is sold to the dealer or manufacturer for a stipulated price instead of being exchanged.⁽⁵⁾

(1) Heiner vs. Tindle, 276 U.S. 582

(2) Laughborough Development Corp. vs. Commissioner, 29 B.T.A. 95A

(3) Welch vs. Commissioner, 19 B.T.A. 394

(4) Hartman Co. vs. Commissioner, 20 B.T.A. 302 A

(5) Montgomery's Federal Income Tax Handbook, 1935-36, pp. 159-160

As to ordinary promissory notes the situation is not clear. It is likely that the courts will consider all aspects of a transaction in deciding whether promissory notes should be considered as securities in a particular case; that is, whether all the facts indicate that a sale occurred and that the notes merely represent the purchase price or whether there was a bona fide exchange and the notes represent part of the property received in exchange.⁽¹⁾

In one case a corporation transferred all assets to another corporation for cash and notes. The Supreme Court referred to the notes thus:

These notes---mere evidence of obligation to pay the purchase price---were not securities within the intendment of the act.⁽²⁾

With the present status of cases, taxpayers may expect the Treasury to rule that promissory notes are or are not securities, according to which results in the greater tax.⁽³⁾

Meaning of "control". It is peculiar that in the case of non-voting stock the law refers to 80% of the number of shares whereas in the case of voting stock it refers to 80% of the stock. When there is more than one class of

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- (1) Montgomery's Federal Income Tax Handbook, 1935-36
 - (2) Pinellos Ice and Cold Storage Co. vs. Commissioner,
287 U.S. 462
 - (3) Montgomery's Federal Income Tax Handbook, 1935-36

voting stock this raises a question as to what constitutes 80% of the stock, since the two classes may be of different par value, or one class may be of no par value, the number of votes per share may be different, etc. There are no decisions interpreting this provision. In arranging transactions under this subsection, the only safe policy is to be sure that, with respect to the voting stock, the transferor has 80% of the number of shares, 80% of the voting power, and also 80% interest in the corporation represented by the voting stock. (1)

Meaning of "immediately after the exchange".

The criterion is whether the subsequent disposition of the stock was the result of an independent contract or in fulfillment of the contract which gave rise to the new corporation. (2)

On the other hand, property was transferred to a corporation by individuals and on the same day, as part of one plan and apparently in accordance with the terms of a contract, the corporation issued stock to another corporation so that at the end of the day the individuals were not in control with the meaning of the law. The Treasury held that the individuals were not in control immediately

(1) Montgomery's Federal Income Tax Handbook, 1935-36, p. 165

(2) Hazeltine vs. Commissioner, 32 B.T.A. 4 N.A.

after transfer but this decision was reversed by the Board. The Board said: "The fact that this control was soon relinquished does not negative the import of the statute, the requirement of which is fulfilled when the transferor is in control immediately after the exchange."⁽¹⁾

Meaning of "substantially in proportion to his interests". When parties are dealing at arm's length, and agree among themselves as to the value of the properties, there is a natural presumption that the securities are issued in proportion to the interest of each in the property. The Board followed this presumption and disregarded the values at which the properties were placed on the books of the new company by the accountants.⁽²⁾

However, the stock may be issued disproportionately because of considerations other than the value of the property. For example, one individual received more stock than he would have been entitled to on the basis of property contributed because of his greater experience in the business.⁽³⁾

Identification of proceeds with expenditures. The Board held that though it is not necessary to earmark the money received, Section 112 F is not complied with if the money is spent for some other purpose and different funds are used to acquire similar property.⁽⁴⁾

(1) C. B. X - 1, 215

(2) General Outdoor Advertising Co. vs. Commissioner, 32 B.T.A. 1011

(3) Record Petroleum Co. vs. Commissioner, 32 B.T.A., 1270

(4) Frischkorn Development Co. vs. Commissioner, 30 B.T.A. 8 A

The taxpayer's steamship was sunk in 1917 and in the same year the excess of the insurance recovered over cost was reported as income. Subsequently in 1928, an award of the difference between the fair market value at the time of loss and the insurance received was made. Before the award was paid, the taxpayer contracted to purchase assets similar in use. It was stipulated that the taxpayer intended to apply all sums to be received on account of the award toward the construction of the new assets and the amounts were so applied on the taxpayer's books. The Board held that this was not sufficient proof of the application of the award to the construction of the ships, but this decision was reversed by the Circuit Court of Appeals.⁽¹⁾

When the front portion of real estate parcels was condemned for street widening and the city withheld from the award an amount representing an assessment for supposed benefit to the rear portions of the real estate, the amount so withheld was allowed to be added to the basis of the entire property in determining the taxable profit from the condemnation award and likewise was considered part of the sale price.⁽²⁾

(1) Wilmore Steamship Co. vs. Commissioner, 30 B.T.A. 866
 (2) Carrano vs. Commissioner, 70 F (2d) 319

Distinction between a merger and a consolidation.

As applied to corporations, the terms "merger" and "consolidation" have well-known legal meanings. While the result is practically the same in either event there is this difference. In a merger one corporation absorbs the other and remains in existence, while the other is dissolved. In a consolidation a new corporation is created and the consolidated corporations are extinguished. In either event the resulting corporation acquires all the property, rights and franchises of the dissolved corporations and their stockholders become its stockholders.(1)

Acquisition of substantially all the properties.

In one case it was held that $91\frac{1}{2}\%$ was "substantially all" and it is further of interest that the court computed the percentage on the net assets rather than on the gross assets.(2)

In the author's opinion, the nature of the properties transferred and the properties retained should be considered in determining whether there is a transfer of "substantially all". If a corporation transfers all of its plant, inventories and goodwill, etc. and retains notes, accounts receivable, cash, etc., "substantially all" might properly be placed at a lower percentage than if the corporation retained part of its plant or business.(3)

(1) Pinellas Ice and Cold Storage Co. vs. Commissioner,
57 F (2d) 188

(2) Cortland Specialty Co. et al. vs. Commissioner,
60 F (2d) 937

(3) Montgomery's Federal Income Tax Handbook, 1935-36. p. 179

When a corporation attempted to bring an exchange within the reorganization definition by transferring all its assets and then receiving back accounts and bills receivable amounting to about 32% of the assets, the Board properly held that there was not in fact a transfer of substantially all the properties.⁽¹⁾

Taxpayer's purpose as affecting reorganization.

It is earnestly contended on behalf of the taxpayer that since every element required by the foregoing subdivision is to be found in what was done, a statutory reorganization was effected; and that the motion of the taxpayer thereby to escape payment of a tax will not alter the result to make unlawful what the statute allows. It is quite true that if a reorganization in reality is effected within the meaning of subdivision (B), the ulterior purpose mentioned will be disregarded. The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them by means which the law permits, cannot be doubted.⁽²⁾ But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended. The reasoning of the court below in justification of a negative answer leaves little to be said.

(1) Arctic Ice Machine Co. vs. Commissioner, 23 B.T.A. 1222
 (2) Jones vs. Helvering, 71 F (2d) 214, 217

When subdivision (B) speaks of a transfer of assets by one corporation to another, it means a transfer made "in pursuance of a plan of reorganization" of corporate business; and not a transfer of assets by one corporation to another in pursuance of a plan having no relation to the business of either, as plainly is the case here. Putting aside, then, the question of motive in respect to taxation altogether, and fixing the character of the proceeding by what actually occurred, what do we find? Simply an operation having no business or corporate purpose--a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner. No doubt, a new and valid corporation was created. But that corporation was nothing more than a contrivance to the end last described. It was brought into existence for no other purpose; it performed, as it was intended from the beginning, it should perform, no other function. When that limited function had been exercised, it immediately was put to death.....The transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision of all serious purpose.⁽¹⁾

(1) Kolvering vs. Gregory, 69 F (2d) 1809

This apparently is a very important case judging from the amount of discussion. From the petitioner's standpoint it looks as though the formation of a new corporation was pure subterfuge to avoid taxes. I do agree that the individual should take all reasonable precautions to cut down on the amount of tax liability. From the point of view of the respondent it seems to me that the motive of tax avoidance does spur the reasoning powers of the court because it now begins to seek out the reason for the reorganization which, it seems to me, gets back to the motives of the organizers, although the court claims to exclude this consideration from its reasoning.

Plan of reorganization. When revenue agents make field examinations in cases involving reorganizations, one of the first questions they generally ask is, "Where is the plan of reorganization?" Frequently, when the minutes are shown setting forth each step in the plan, the agents are not satisfied because there is no printed document headed Plan of Reorganization.

The law does not even require that there be a plan in writing. However, in taxation many difficulties can be avoided by complying strictly and literally with the language of the law and regulations and it is accordingly desirable that a plan of reorganization be drawn up and so

(1) *Harmon's Federal Income Tax Handbook*, 1931-32, p. 127.
 (2) *United A. Lindbergh vs. United States*, 2 S.Ct. 77-784

labeled, either in the minutes or as a separate document, that the plan contain every step that is to be accomplished in the reorganization, and that it be adopted at appropriate meetings before any of the steps are effected.

In practice, the form of minutes and documents, as well as the form of the transactions themselves, is of the greatest importance. It is usually just as easy to consummate a technically impregnable reorganization as a doubtful one if proper care is exercised.⁽¹⁾

Form and substance. Speaking generally, in determining what was actually done in any case, this Board will regard substance rather than form. However, material and essential facts will not be dismissed or put aside as mere matters of form simply because they are related to and are steps in a comprehensive plan of reorganization, or together constitute a method of attainment of a single desired result.⁽²⁾

In regard to one aspect of "boot" there are conflicting decisions. An individual acquired real estate, paying part cash and giving notes for the balance secured by a lien on the property; several years later he transferred the property to a corporation for capital stock, the corporation assuming the liability on the notes. The

(1) Montgomery's Federal Income Tax Handbook, 1935-36, p. 190

(2) Edward A. Langenback vs. Commissioner, 2 B.T.A., 777-784

Board sustained the Treasury in holding that the assumption of the liability did not constitute "boot" and that the stockholder realized no gain or loss upon the transfer to the corporation.(1)

In this case, the taxpayer, either individually or through trusts, owned certain clay and coal properties. The trustees had outstanding obligations, represented by notes, in their capacity as trustees, amounting to \$2,000,000. All of the properties were transferred to a newly organized corporation in exchange for all of the capital stock of the corporation plus \$2,423,944.48 in notes of the corporation which were shortly paid out of proceeds of a bond issue. The corporation assumed the \$2,000,000 of trustees' notes which it promptly paid. The Board held that assumption of the notes constituted taxable boot.(2)

Identification and apportionment of basis. The rule followed by the Treasury, the Board, and the courts is that if the certificates sold can be identified, the basis is the cost of the particular securities sold. If the certificates cannot be identified, the first securities purchased are considered to be the first sold, usually referred to as the "first-in, first-out rule".(3)

(1) Fashion Center Building Co. vs. Commissioner, 31 B.T.A. 167

(2) Dickey vs. Commissioner, 32 B.T.A. 1283 A

(3) ~~H~~evering vs. Rankin, 55 Supreme Court 732

An exception is made when the evidence clearly shows that the taxpayer intended to sell later acquired certificates although earlier acquired certificates were delivered to the vendee,⁽¹⁾ but mere intent unaccompanied by some overt act, such as instruction to the broker, is insufficient to bring a case within the exception.⁽²⁾

When the taxpayer's earliest purchased shares were put into his broker's account after various other late purchases were made through the account, an unidentified sale of stock was presumed to be from the earliest purchases and not the stock first placed in the account.⁽³⁾

Under the present law it pays taxpayers to keep records and identify securities whenever possible so that they may sell either high or low cost securities, securities held over a period of years, or securities recently acquired.⁽⁴⁾

In regard to stock rights, no adjustment is required in the basis of the original stock if, through decline in the market prices, the rights become worthless prior to expiration date, although at the time of issuance they may have had substantial value.⁽⁵⁾ Nor may any deduction for loss sustained be taken when the rights are allowed to lapse.⁽⁶⁾ The Board's position is of doubtful legality.

(1) Howbert vs. Penrose, 38 F (2d) 577

(2) Horner vs. Commissioner, 28 B.T.A. 360

(3) Forrester vs. Commissioner, 32 B.T.A. 745

(4) Montgomery's Federal Income Tax Handbook, 1935-36, p. 210

(5) General Counsel's Memoranda 11873

(6) Eastern Shares Corp. vs. Commissioner, 32 B.T.A. 608

A stockholder may actually have lost part of his interest in the corporation and such loss should be deductible.

Since 1921 the laws had provided that in case of property acquired by gift after December 31, 1920, the basis for computing either gain or loss was cost or other basis to the donor. The 1934 law makes a substantial change. The basis now for computing gain is the same as under prior laws: the basis of the donor or the last preceding owner by whom it was not acquired by gift. The basis for computing loss is the donor's basis or the fair market value at the time of gift, whichever is lower. The purpose of the change was to prevent members of a family from minimizing taxes by making inter-family gifts and thus transferring losses to the members of the family to whom they would yield the greatest tax benefit.⁽¹⁾

The constitutionality of requiring a donee to use the donor's basis has been upheld by the Supreme Court.⁽²⁾

Whenever property passes from a decedent the basis is the fair market value at the time of its acquisition. The phrase "time of acquisition" was interpreted as the death of the decedent.⁽³⁾

(1) Montgomery's Federal Income Tax Handbook, 1935-1936, p. 214

(2) Taft vs. Bowers, 278 U.S. 470

(3) Brewster vs. Gage, 280 U.S. 327

Capital Assets. Any property is a capital asset unless it may properly be included in an inventory or is held for sale to customers.

In determining whether property is a capital asset, the period for which it is held is immaterial. Capital assets are not limited to stock or securities. They may be assets held for personal use or consumption, such as residences, occupied by the taxpayer, automobiles, jewels and similar items. Commodity futures are capital assets if not held for sale to customers.⁽¹⁾

The interest of a partner in a partnership is regarded as a capital asset.⁽²⁾

Determination of period property is held. The date of acquisition is to be excluded and the day of sale included.⁽³⁾

The period begins to run from the date of the taxpayer's acquisition of the property and not from the date of payment therefor or the date when additional costs in respect thereof were incurred.⁽⁴⁾

Where the taxpayer and another agreed to form a corporation and to subscribe for all the stock, and the

(1) Montgomery's Federal Income Tax Handbook, 1935-1936, p. 229

(2) Humphrey vs. Commissioner, 32 B.T.A. 280 N.A.

(3) Hooper vs. Commissioner, 26 B.T.A. 758

(4) Shaffer vs. Commissioner, 28 B.T.A. 1293 N.A.

taxpayer's share of the stock was issued to him in several instalments, the effective dates of acquisition were the dates of the issuance of each instalment of the stock to the taxpayer and not the date of the subscription agreement.⁽¹⁾

In concluding this chapter, one of the doubtful points lies in connection with promissory notes. When property is being exchanged care must be exercised if notes are to have the status we expect them to have. The question hinges on whether notes should be considered as securities or as part of the purchase price. Which of these two stands will be taken by the Treasury will probably depend upon which method results in the greater tax.

Another situation where accountants and the Board may disagree is with regard to the issue of stock relative to the individual's interest in the property. Take for example the change from a partnership to a corporation. The Board has disregarded the new values placed upon the corporate records and considered the holdings of the new stockholders in the light of the old partners' holdings.

(1) *Sommers vs. Commissioner*, 63 F (2d) 551

CHAPTER IX

CONCLUSION

We cannot argue with the courts. Since the great increase in the scope of our income tax laws the accounting for business has been brought more into the courts so that a wide range of accounting concepts have been subjected to legal investigation. As stated previously, the court decision is final regardless of the possibility of error.

As to the decisions of the courts and the Board of Tax Appeals we find that a decision unfavorable to the Commissioner is very rare.

Keeping these two truths in mind, it seems plain that wherever possible the operation of our records should follow the interpretation of the law as propounded by the court decisions.

A great part of the business of this country is still carried on by the comparatively small organization. Perhaps the financial records were not installed by a qualified technician and most of the reports are made out by the bookkeepers. According to experience of some tax men, at least, this kind of organization usually pays more tax than it should rather than less. The best prevention for this situation, and I use prevention rather than refund because

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the latter is difficult to obtain now and the difficulty increases with the passing of time, is a closer cooperation between small business and accountants and between accountancy and the law. It may be that the small concern feels that it cannot afford all of this help. In such a case it would be advisable to use some of the up-to-date sources of information like Robert Montgomery's Federal Income Tax Handbook, the Prentice-Hall, or like, tax services, and the Journal of Accountancy.

Without being unduly pessimistic, it seems to me that government finance with its unbalanced budgets is going to necessitate still greater income and perhaps one of the major sources will be the establishment of income taxes on lower incomes. In fact, I believe we are soon coming to the place where all income above enough for mere existence will be subject to income tax. Such an arrangement may be far from outrageous for as it is the rich feel that they are (alone) paying the bulk of the taxes of the country, which causes them in retaliation to raise sale prices, which in turn places all the burden upon the consumer. To place a little more direct tax on the small income may be a means of bringing the capitalist to see his growing responsibility to labor.

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Of course, all of this indicates that after a case in some accounting principle has been decided by some authoritative body, we can proceed in a rather definite direction. Unfortunately this is not true. Many instances may be shown where the decision of one court conflicts with the decision of another. The result is that nothing certain can be established until at some future time the question may reach the Supreme Court of the United States. In the meantime, competent tax advice may keep the taxpayer out of trouble and perhaps save him considerable money.

In case of a doubtful tax situation the taxpayer should cite in detail the facts in writing to the Commissioner for a ruling. This officer has wide power, including discretionary powers. Any change of method contemplated must be submitted for his approval. Evidence indicates that his power weighs decidedly in favor of the Government rather than as an impartial arbiter.

However, the individual should not feel that he is entirely at the mercy of the taxing powers for, though most of the courts frown upon such procedure, it is perfectly legal to avoid taxes by proper treatment. This procedure must be carried on with care, because the taxpayer's activities may be considered to be outside the law if it can be shown that his only motive for the action was tax

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reduction. This does not have the same meaning as evasion of taxes, which is strictly an illegal means of attempting to reduce one's tax bill.

In conclusion, we may say that in a majority of cases the courts uphold general accounting principles, but there are so many cases where the usual, the generally understood method of treatment is shattered by the courts that, unless proper investigation of the exceptions is carried on, very serious difficulty is practically certain to arise.

Remember that according to the Supreme Court of the United States, books of account "are no more than evidential, being neither indispensable nor conclusive. The decision must rest on the actual facts".

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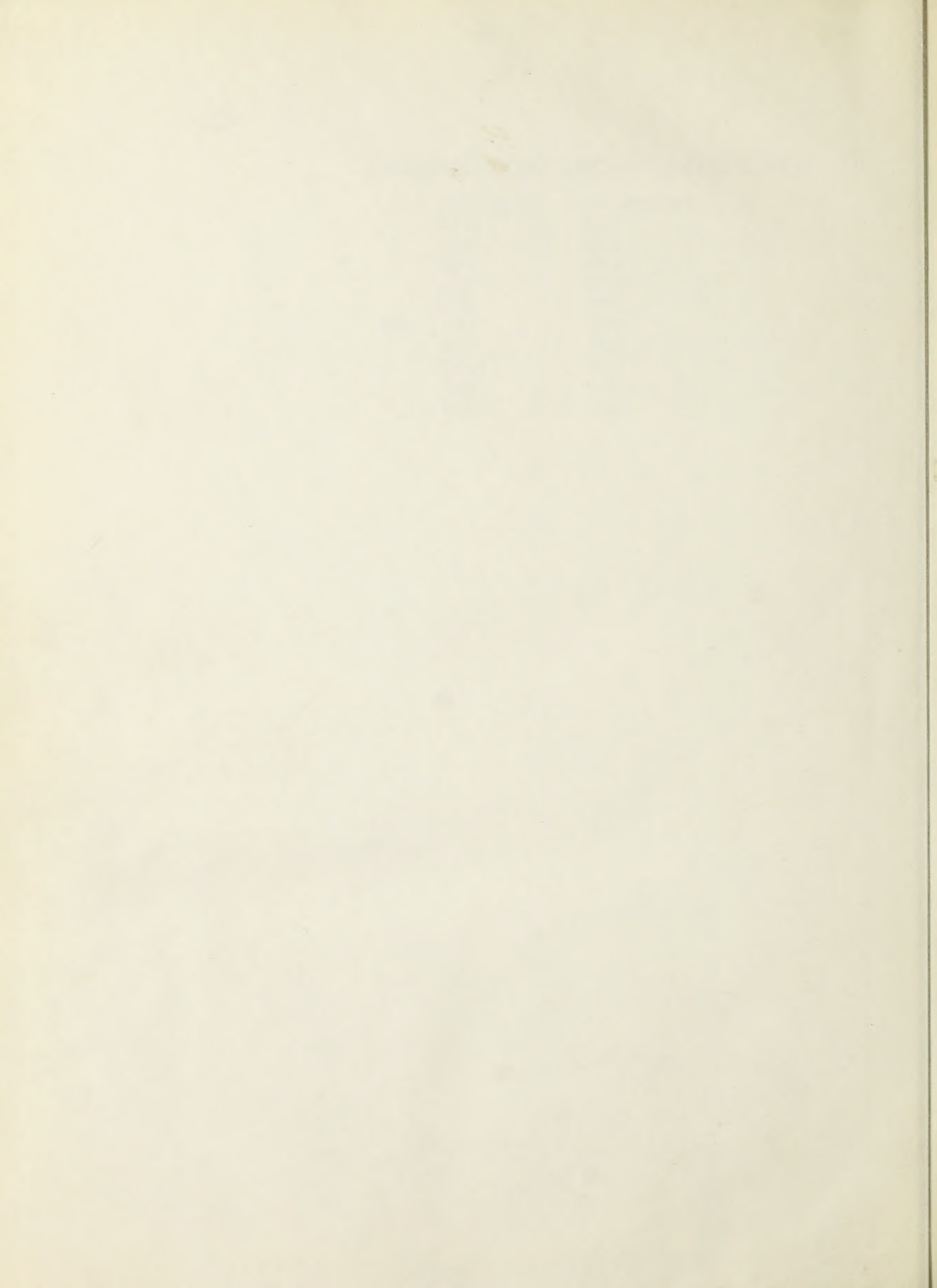
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